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IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

IN THE MATTER OF: SOUTHMARK CORPORATION,
Debtor.

SOUTHMARK CORPORATION,
Petitioner,

v.

COOPERS & LYBRAND L.L.P.,
Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether an Article I bankruptcy court violates Article III of the Constitution when it exercises jurisdiction over and decides a state-law tort claim that arose during Chapter 11 proceedings.

PARTIES TO THE PROCEEDINGS AND RULE 29.6 STATEMENT

Petitioner is Southmark Corporation. Respondent is Coopers & Lybrand L.L.P. In addition to the parties listed in the caption, the following were parties below: Charles B. Brewer and Thompson & Knight. Southmark is not a parent or subsidiary of any publicly held corporation or any other publicly held entity.

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On Petition For A Writ Of Certiorari
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PETITION FOR A WRIT OF CERTIORARI

Petitioner Southmark Corporation ("Southmark") respectfully submits this petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a) is reported at 163 F.3d 925. The ruling of the district court, rendered orally from the bench, is reproduced at App., *infra,* 27a. The opinion of the bankruptcy court is reproduced at App., *infra*, 33a.

JURISDICTION

The judgment of the court of appeals was entered on January 11, 1999. App., *infra*, 1a. This petition is timely filed pursuant to Supreme Court Rules 13 and 30. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article III, Section 1 of the United States Constitution and the pertinent provisions of the United States Code, 28 U.S.C. §§ 157 & 1334(c)(2), are reproduced at App., *infra*, 73a-77a.

STATEMENT OF THE CASE

This case presents the question whether a bankruptcy court may decide a state-law malpractice claim without violating the constitutional limits this Court recognized in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). The jurisdiction of an Article I bankruptcy court is quite narrow: absent consent of the litigants, it may only decide controversies that arise under Title 11 or that lie "at the core of the federal bankruptcy power." *Id.* at 71. If a controversy is unconnected with, or merely "related to" bankruptcy, the court may not decide it. The United States Court of Appeals for the Fifth Circuit held that Southmark's ordinary state-law malpractice claim fell within the bankruptcy court's core jurisdiction on the basis of its tenuous connection to a Chapter 11 reorganization that had concluded nearly five years before.

The court of appeals' expansive interpretation of the core of bankruptcy demolishes the delicate jurisdictional structure this Court established in

Marathon. Under the Fifth Circuit's reasoning, a litigant in an ordinary state-law tort suit forfeits his constitutional right to an Article III decisionmaker merely because the tort was committed during a bankruptcy proceeding. Review of this decision is necessary to demark the constitutional limits on the decisionmaking powers of Article I bankruptcy courts.

1. Southmark's state-law claims arose as a result of Coopers & Lybrand's ("Coopers") tortious conduct while performing accounting services in connection with Southmark's Chapter 11 reorganization. Southmark is a real estate investment trust that sponsored private and publicly syndicated real estate partnerships throughout the 1980's. App., *infra*, 2a. From 1982 until shortly before Southmark filed for bankruptcy in 1989, Drexel Burnham Lambert, Inc. ("Drexel") served as Southmark's primary investment banker, underwriter, securities broker, and investment and financial advisor. Drexel served as the underwriter for over $1 billion of junk bonds and preferred stock offered by Southmark. *Id.* In its role as financial advisor, Drexel pressured Southmark to issue these securities, the proceeds of which would be used to purchase junk bonds of other Drexel clients. As a result of Drexel's scheme, in October 1986 Southmark issued $400 million in junk bonds and $100 million in preferred stock. *Id.* at 3a. All of the junk bond proceeds and part of the stock revenues were promptly used to buy other junk bond securities. *Id.*

In April 1989, Southmark announced a $1 billion write-down of its asset values, wiping out shareholders' equity. *Id.* In July 1989, Southmark filed for bankruptcy under Chapter 11. Shortly

thereafter, Southmark requested the appointment of an Examiner to provide "an unbiased, independent assessment of the propriety and practicality of pursuing litigation against third-parties." *Id.* The Examiner applied to the bankruptcy court to retain Coopers as accountant to the Examiner. Although Coopers noted that it performed some accounting work for Drexel, it failed to disclose that it was Drexel's outside auditor. *Id.* Nor did Coopers reveal that Drexel paid Coopers "approximately $6.7 million for 1987 services, $6.9 million for 1988 services and $4.9 million for 1989 services." *Id.* at 45a.

Coopers assigned responsibility for investigating Southmark's possible claims against Drexel to a manager, William Galbally. *Id.* at 47a. After a preliminary month-long investigation, Galbally concluded that Southmark could assert substantial legal claims against Drexel and that further investigation was warranted. *Id.* In a meeting with David Carpenter, the head of the Coopers engagement team for the Southmark project, Galbally reported his conclusions and declared that the claims against Drexel would be the biggest issue in the engagement. Record ("R."), Vol. III at 259. Carpenter was infuriated by Galbally's report and yelled, "Don't fuck with Drexel. Drexel is our largest audit client." *Id.*; R., Vol. VII, tab 1 at 28-29. The meeting ended with Carpenter removing Galbally from the Drexel investigation. App., *infra*, 48a.

In March 1990, Coopers orally presented to the Examiner its findings on various issues, including the Drexel investigation. R., Vol. II at 64. This presentation was shortly followed by a written report focusing on Drexel; this report, delivered to

the Examiner, contained Coopers' final conclusions concerning Southmark's potential claims against Drexel. *Id.*; R., Vol. VII, tab 3 at 72. The report was plainly based on a half-hearted and incomplete investigation of Drexel's misconduct. It concluded that "the buyers of Southmark securities may be able to put forth a class action type claim against Drexel for lack of due diligence or the like but a claim on behalf of the estate is not readily apparent." R., Vol. VII, tab 2 at 81. The Examiner's report integrated these conclusions and advised that although Southmark's potential claims had been "extensively" investigated, they would be difficult to prove. R., Vol. III at 266, 271.

Southmark emerged from bankruptcy in August 1990, and immediately began to pursue various claims identified by the Examiner. Drexel's parent company had declared bankruptcy earlier in the year and the court had set a November bar date for filing claims against the estate. App., *infra*, 45a. Because the Examiner's report had failed to identify any substantial claims Southmark might assert against Drexel, Southmark declined to authorize any further investigation. R., Vol. 7, tab 5 at 8-14. In the end, Southmark filed no claim in the Drexel bankruptcy. App., *infra*, 4a. Instead, in early 1991, Southmark engaged outside counsel to investigate Drexel-related claims with an eye toward pursuing claims against Michael Milken—an investigation that paralleled the inquiry Galbally had intended to conduct before his sudden removal. R., Vol. VII, tab 5 at 16-17 & tab 1 at 36-37. Ultimately, Southmark reached a settlement agreement that yielded more than $30 million from the Milken settlement fund.

2. Galbally, still employed by Coopers, stepped forward in April 1993—over two-and-a-half years after Southmark emerged from bankruptcy—and disclosed to Southmark's general counsel the circumstances surrounding his aborted investigation and removal from the case. App., *infra*, 4a. Southmark promptly launched an investigation into Coopers' conduct and filed a motion for disgorgement in the bankruptcy court, seeking reconsideration of the award of fees to Coopers during its Southmark engagement. *Id.* The motion was premised on Coopers' failure to satisfy the bankruptcy court's disclosure and disinterestedness requirements. R., Vol. II at 13-18. Southmark sought only a disgorgement of fees; it did not seek recovery for the damages it suffered as a result of Coopers' deception. The bankruptcy court granted the motion and awarded Southmark roughly $585,000, which included a portion of the fee paid to Coopers for the engagement in addition to Southmark's attorneys' fees. App., *infra*, 4a, 56a. The court found that "Coopers' failure to fully disclose connections and activities with and regarding Drexel prevented the court from fully performing its function under the Bankruptcy Code and thereby frustrated the purposes of the Code to assure that the professional person employed by the examiner tenders undivided loyalty and provides untainted advice and assistance." *Id.* at 52a.

3. In April 1995, nearly *five years* after emerging from bankruptcy, Southmark sued Coopers in the 134th Judicial District Court, Dallas County, Texas, seeking money damages under Texas law for breach of contract, fraud and deceit, breach of fiduciary duty, and negligent misrepresentation. *Id.* at 67a-71a. The complaint alleged that Coopers' failure to conduct a reasonably

thorough investigation deterred Southmark from pursuing potential claims against Drexel or filing a proof of claim in the Drexel bankruptcy. *Id.* at 66a. Coopers removed the action to the United States Bankruptcy Court for the Northern District of Texas, which had presided over Southmark's Chapter 11 case. Southmark then filed a motion for mandatory abstention or, in the alternative, discretionary abstention or remand, on the grounds that its state-law malpractice claim was a non-core proceeding required to be returned to state court under 28 U.S.C. § 1334(c)(2). *Id.* at 5a. Coopers responded by filing a motion for judgment on the pleadings, contending that the prior disgorgement proceeding collaterally estopped Southmark from claiming that Coopers' misconduct caused Southmark to suffer damages.

The bankruptcy court granted Coopers' motion for judgment on the basis of both issue and claim preclusion, and denied as moot Southmark's motion for abstention. *Id.* at 41a-42a. The United States District Court for the Northern District of Texas affirmed, finding that Southmark's malpractice claim fell within the bankruptcy court's core jurisdiction. *Id.* at 30a. Although the bankruptcy court had failed to make any sort of jurisdictional finding, the district court determined that such a finding was implicit in the ruling. *Id.* at 30a-31a.

The United States Court of Appeals for the Fifth Circuit affirmed the district court, holding that "the state-law malpractice claim is a 'core proceeding' in bankruptcy" and that the prior disgorgement proceeding gave rise to issue preclusion. *Id.* at 2a. The court reasoned that although Southmark's cause of action arose under state law, it nonetheless fell within the bankruptcy court's core jurisdiction

because it was "inseparable from the bankruptcy context." *Id.* at 12a. The court noted that two of Southmark's allegations—its breach of fiduciary duty and breach of contract claims—implicated contractual terms that were approved by the bankruptcy court. *Id.*

Acknowledging the *Marathon* Court's holding that the core of the federal bankruptcy power is "the restructuring of debtor-creditor relations," 458 U.S. at 71, the court of appeals explained that "[a] *sine qua non* in restructuring the debtor-creditor relationship is the court's ability to police the fiduciaries . . . responsible for managing the debtor's estate." App., *infra*, 12a. Moreover, "[a]ward of the professionals' fees and enforcement of the appropriate standards of conduct are inseparably related functions of bankruptcy courts." *Id.* at 13a. Finally, the court characterized Southmark's claim as "one to recover an asset of Southmark's estate that Coopers let slip away," and therefore an appropriate dispute for the bankruptcy court to decide. *Id.* at 14a.

Having satisfied itself that the bankruptcy court properly exercised jurisdiction, the court of appeals next concluded that Southmark was collaterally estopped from claiming that Coopers' misconduct caused it to suffer damages. The court reasoned that the issue was actually litigated and resolved in the disgorgement proceeding. *Id.* at 16a-20a. Although the court criticized the lower courts' "rather perfunctory reliance on claim preclusion" and cast doubt on their conclusions, it nonetheless affirmed the lower courts' dismissal of Southmark's case on the basis of issue preclusion. *Id.* at 20a.

REASONS FOR GRANTING THE WRIT

Seventeen years ago, in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), this Court struck down Congress' attempt to expand beyond constitutional bounds the jurisdiction of Article I bankruptcy courts. The Court held that a bankruptcy court can decide only those controversies that fall within "the core of the federal bankruptcy power"—a narrow zone limited to matters involving "the restructuring of debtor-creditor relations . . . [as] distinguished from the adjudication of state-created private rights." *Id.* at 71. Lower courts have since struggled to define precisely what types of claims are included within "core" jurisdiction, their task complicated by the ambiguous bankruptcy statute enacted in *Marathon*'s wake.

The result of this confusion is well illustrated by the Fifth Circuit's decision below. Confronted with a claim requiring "the adjudication of state-created private rights," the court relied on broad statutory language and policy goals to implement its expansive vision of the role of bankruptcy courts—a vision directly at odds with the jurisdictional limits imposed by Article III and upheld by this Court in *Marathon*. Review is warranted to resolve this substantial and important issue of constitutional law and to clarify the permissible scope of bankruptcy courts' jurisdiction.

I. The Court Of Appeals' Holding That A Bankruptcy Court May Decide A State-Law Tort Claim Is Irreconcilable With This Court's Decision In *Marathon*

In *Marathon*, this Court held that Congress could not vest Article I bankruptcy courts with the

authority to adjudicate state-created private rights. In the 1978 Bankruptcy Code, Congress had delegated to untenured bankruptcy judges all jurisdiction conveyed to the Article III district courts. The Court struck down this provision on separation-of-powers grounds, warning that such a sweeping jurisdictional grant "threatens to supplant completely our system of adjudication in independent Art. III tribunals and replace it with a system of 'specialized' legislative courts." 458 U.S. at 73.

Bankruptcy courts were not left powerless, however. The Court explained that bankruptcy courts could, consistent with Article III, adjudicate matters involving "the restructuring of debtor-creditor relations" that fall within "the core of the federal bankruptcy power." *Id.* at 71. But the Constitution forbids their "adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case." *Id.*[1] Congress incorporated *Marathon*'s core/non-core distinction in passing the Bankruptcy Amendments and Federal Judgeship Act of 1984, which permits

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[1] Courts, including the court of appeals below, App., *infra*, 9a, have often looked to Chief Justice Burger's opinion as the narrowest interpretation of the plurality's holding. *See Marathon*, 458 U.S. at 92 (Burger, C.J., dissenting) ("[T]he Court's holding is limited to the proposition . . . that a 'traditional' state common-law action, not made subject to a federal rule of decision, and related only peripherally to an adjudication of bankruptcy under federal law, must, absent the consent of the litigants, be heard by an 'Art. III court.'"). *See also Thomas v. Union Carbide Agric. Prods. Co.*, 473 U.S. 568, 584 (1985) (citing Burger, C.J., dissenting opinion).

bankruptcy judges to "hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11." 28 U.S.C. § 157(b)(1). The statute provides a non-exclusive list of specific matters and claims that fall within core jurisdiction. *See* 28 U.S.C. § 157(b)(2).

In the decision below, the Fifth Circuit agreed with the bankruptcy judge that Southmark's claims fell within the bankruptcy court's core jurisdiction and accordingly upheld its decision not to abstain.[2] In reaching this result, the court relied on the reconfigured jurisdictional statute, coupled with a breathtaking mischaracterization of the nature of Southmark's claim, to achieve indirectly what *Marathon* prevents Congress from doing directly—empower bankruptcy courts to adjudicate state-law controversies that have no bearing on the restructuring of debtor-creditor relations.

A. The Core Of The Federal Bankruptcy Power Does Not Encompass State-Law Tort Suits

The Fifth Circuit's conclusion that Southmark's state-law tort claims fall within a bankruptcy court's core jurisdiction is flatly contradicted by *Marathon* and, if followed by other courts, will erode the constitutional limits on Article I courts. As the court of appeals acknowledged, App., *infra*, 11a-12a, Southmark's claims arose under Texas law; its right to sue Coopers for breach of contract, fraud, breach

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[2] A bankruptcy judge is required to abstain under 28 U.S.C. § 1334(c)(2) in non-core state-law claims that lack any other basis for federal jurisdiction and that can be timely adjudicated in a state forum of appropriate jurisdiction.

of fiduciary duty and negligent misrepresentation were conferred not by the federal bankruptcy code but by the State of Texas.[3] Moreover, as the court of appeals explained, Texas law also provided the standard by which Coopers' liability would be judged. *Id.* at 13a (noting that "standards for the conduct of court-appointed professionals, the breach of which may constitute bankruptcy malpractice, are not comprehensively expressed in the [Bankruptcy Code]"). Accordingly, the substantive nature of Southmark's claims fall squarely within the category of "state-created private rights" that must be adjudicated by an Article III court. *Marathon*, 458 U.S. at 71. As Judge Posner has recognized, core jurisdiction must be confined to causes of action conferred by the Bankruptcy Code. *See In re United States Brass Corp.*, 110 F.3d 1261, 1268 (7th Cir. 1997) ("Core proceedings are actions by or against the debtor that arise under the Bankruptcy Code in the strong sense that the Code itself is the source of the claimant's right or remedy, rather than just the procedural vehicle for the assertion of a right conferred by some other body of law, normally state law.").

The court below sought to escape this obvious conclusion by insisting that because the tort claims

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[3] Section 157(b)(3) provides that "[a] determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law." 28 U.S.C. § 157(b)(3). This statutory provision, of course, cannot be interpreted to expand the core jurisdiction of Article I judges beyond the constitutional boundaries established in *Marathon*. In any event, the Subsection merely provides that a claim arising under state law is not *automatically* deemed non-core.

arose in a "bankruptcy setting," App., *infra*, 12a, they fell within the core of the federal bankruptcy power. This rationale is plainly insufficient under *Marathon*, which limited bankruptcy courts' jurisdiction to a narrow subset of cases arising *within* the bankruptcy setting. Indeed, the very facts of *Marathon* illustrate this point: a Chapter 11 debtor brought a state-law action for breach of contract and warranty, misrepresentation and duress, yet the Court held that the mere fact these claims arose in a bankruptcy setting was insufficient to trigger core jurisdiction. The heart of the inquiry, the Court explained, is the substantive nature, public or private, of the asserted right. If the right is a private right—one which involves "the liability of one individual to another"—it must be decided by an Article III court. *Id.* at 69-70 (citation omitted). As this Court stated in *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 56 (1989), *Marathon* "emphasized that state-law causes of action for breach of contract or warranty are paradigmatic private rights, even when asserted by an insolvent corporation in the midst of Chapter 11 reorganization proceedings," and therefore inappropriate for resolution by anything other than an Article III court.

The post-*Marathon* jurisprudence of this Court confirms that untenured bankruptcy judges are constitutionally forbidden from adjudicating the types of claims at issue here. In *Granfinanciera*, the Court held that a defendant sued by the bankruptcy trustee for a fraudulent conveyance was entitled to a jury trial because such claims "constitute no part of the proceedings in bankruptcy but concern controversies arising out of it" and therefore were matters of private right. 492 U.S. at 56 (quoting *Schoenthal v. Irving Trust Co.*, 287 U.S. 92, 94-95

(1932)).[4] The Court reasoned that fraudulent conveyance claims "more nearly resemble state-law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Id.* It concluded that because the action was not "integral to the restructuring of debtor-creditor relations[,] Congress therefore cannot divest petitioners of their Seventh Amendment right to a trial by jury." *Id.* at 58-59. Southmark's claim here is no different from the claim in *Granfinanciera*: It is a private tort claim that is not "integral to the restructuring of debtor-creditor relations" and should not have been adjudicated by an Article I judge.[5]

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[4] The Court prefaced its discussion by explaining that its analysis whether the defendant was entitled to a jury trial was identical to the analysis whether Congress could empower a bankruptcy judge to adjudicate the matter. *See Granfinanciera*, 492 U.S. at 53 (citation omitted): "Indeed, our decisions point to the conclusion that, if a statutory cause of action is legal in nature, the question whether the Seventh Amendment permits Congress to assign its adjudication to a tribunal that does not employ juries as factfinders requires the same answer as the question whether Article III allows Congress to assign adjudication of that cause of action to a non-Article III tribunal. For if a statutory cause of action . . . is not a 'public right' for Article III purposes, then Congress may not assign its adjudication to a specialized non-Article III court lacking the essential attributes of the judicial power."

[5] Other decisions by this Court have reaffirmed *Marathon*'s central holding. In *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 850 (1986), the Court explained that "Article III, § 1, safeguards the role of the Judicial Branch in our tripartite system by barring congressional attempts to transfer

In fact, in *Granfinanciera*, this Court went a step further, casting doubt on the legitimacy of virtually *any* final adjudication by bankruptcy judges. The Court cautioned, "[w]e do not suggest that the restructuring of debtor-creditor relations is in fact a public right." 492 U.S. at 56 n.11. If the restructuring of debtor-creditor relations falls outside the sphere of matters that may be adjudicated by Article I judges, it is inconceivable that a tort claim arising between two private parties is included within a bankruptcy court's core jurisdiction.

Furthermore, the undisputed fact that Southmark filed its state-law action nearly five years after emerging from bankruptcy illustrates how far removed this case is from the core of the federal

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jurisdiction to non-Article III tribunals for the purpose of emasculating constitutional courts, and thereby preventing the encroachment or aggrandizement of one branch at the expense of the other" (citations and brackets omitted). The Court underscored its duty to scrutinize congressional attempts to control the adjudication of "rights [that] were historically . . . subject to resolution by Article III courts." *Id.* at 854. *See also Thomas*, 473 U.S. at 584 (*Marathon* establishes that "Congress may not vest in a non-Article III court the power to adjudicate, render final judgment, and issue binding orders in a traditional contract action arising under state law, without consent of the litigants, and subject only to ordinary appellate review."); *Celotex Corp. v. Edwards*, 514 U.S. 300, 316, 323 (1995) (Stevens, J., dissenting) (noting that "the jurisdiction and the power of bankruptcy judges are cabined by specific and important . . . constitutional constraints" and questioning Bankruptcy Code's delegation of jurisdiction to Article I judges).

bankruptcy power. Southmark's claims were adjudicated not in the context of an ongoing bankruptcy proceeding, but long after the proceeding had ended. This immense time lapse further undercuts the court of appeals' conclusion that Southmark's 1995 action involves the restructuring of debtor-creditor relations—a restructuring that had ended by 1990.[6]

In addition to encroaching on the separation of powers, the ruling below also threatens fundamental principles of federalism. Southmark's state-law claim was adjudicated by a federal bankruptcy court that lacked any basis for federal jurisdiction save for a tangential and tenuous connection to a long-concluded bankruptcy proceeding. Southmark's claim did not raise a federal question, nor did either party even allege the existence of diversity jurisdiction. This Court has historically upheld "[t]he power reserved to the states, under the Constitution, to provide for the determination of controversies in their courts." *Healy v. Ratta*, 292 U.S. 263, 270 (1934). *See also* 13 Charles Alan Wright et al., FEDERAL PRACTICE AND PROCEDURE § 3522, at 61-62 (2d ed. 1984) ("[I]t would not simply be wrong but indeed would be an unconstitutional invasion of the powers reserved to

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[6] Because Coopers' duty to disclose its conflict of interest was ongoing, *see* App, *infra*, 47a, 11 U.S.C. § 327(a), *In re Sauer*, 191 B.R. 402, 407 (Bankr. D. Neb. 1995), its tortious conduct also encompassed the four-month post-confirmation period from July to November 1990. *See Pettibone Corp. v. Easley*, 935 F.2d 120, 122 (7th Cir. 1991) ("Once the bankruptcy court confirms a plan of reorganization, the debtor may go about its business without further supervision or approval.").

the states if the federal courts were to entertain cases not within their jurisdiction."). By ruling on issues of Texas law with no independent basis for federal jurisdiction, the federal bankruptcy court wrongly usurped the prerogative of the Texas state courts and denied Southmark its right to have its state-law claims adjudicated in state court.

The vehicle for this unjustified intrusion on the state courts was 28 U.S.C. § 1334(c)(1), which empowers federal bankruptcy courts to determine even pure questions of state law that are deemed to fall within core jurisdiction. In this way, the court of appeals' expansive vision of core jurisdiction endangers not only the separation of powers, but directly threatens long-recognized principles of federalism. Permitting important questions of state law to be determined by a non-tenured federal bankruptcy judge—particularly, as here, in the absence of *any* connection to an ongoing bankruptcy proceeding—amounts to a dangerous and needless expansion of federal jurisdiction.

B. A Bankruptcy Court's Purported Duty To "Police The Fiduciaries" Cannot Justify Evading The Limits of *Marathon*

The court of appeals reasoned that Southmark's claims fell within core jurisdiction because they implicated "the court's ability to police the fiduciaries . . . who are responsible for managing the debtor's estate in the best interest of creditors." App., *infra,* 12a. This novel argument rests upon a profound mischaracterization of Southmark's claim. Southmark sued Coopers in tort to vindicate a *private* right conferred under Texas law. Any *public* interest in ensuring that Coopers' conduct

conformed to law was satisfied by the disgorgement proceeding. The bankruptcy court expressly recognized this point. In ordering Coopers to disgorge $585,000 in fees and other expenses, it determined that "Coopers' failure to fully disclose connections and activities with and regarding Drexel prevented the court from fully performing its function under the Bankruptcy Code and thereby frustrated the purposes of the Code to assure that the professional person employed by the examiner tenders undivided loyalty and provides untainted advice and assistance." *Id.* at 52a.

A bankruptcy court's ability to police court-appointed professionals is not hampered in the least by denying it jurisdiction over malpractice claims. The Bankruptcy Code grants bankruptcy judges a variety of means of policing its appointees, including sanctions under 11 U.S.C. § 105(a), disqualification under 11 U.S.C. § 327, and—as illustrated here—disgorgement under 11 U.S.C. § 328. Stretching the bounds of Article III to protect a public interest already secured in so many other ways is therefore wholly unjustified. Even if private tort suits are somehow deemed to serve a marginal public "policing" purpose, "the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution." *Bowsher v. Synar*, 478 U.S. 714, 736 (1986) (citation omitted). In any event, by anointing the "policing" function a "*sine qua non* in restructuring the debtor-creditor relationship," App., *infra*, 12a, the Fifth Circuit empowers bankruptcy courts to decide any matter even remotely involving court-appointed professionals on the basis of a policy goal already realized in the Bankruptcy Code itself.

The court of appeals also suggested that core jurisdiction existed because "[s]upervising the court-appointed professionals . . . bears directly on the distribution of the debtor's estate" and that "[i]f the estate is not marshaled and liquidated or reorganized expeditiously, there will be far less money available to pay creditors' claims." *Id.* at 13a. But the fact that Coopers' honest and expeditious performance of its duties would have financially benefited Southmark's estate is immaterial under *Marathon*. *See* 458 U.S. at 71-72 ("Appellant Northern's right to recover contract damages *to augment its estate* is one of private right" and therefore falls outside core jurisdiction.) (citation omitted and emphasis added). Permitting bankruptcy courts to decide claims involving any conduct that may have a financial effect on an estate would result in an exponential expansion of core jurisdiction.

C. The Bankruptcy Statute Cannot Be Interpreted To Grant Bankruptcy Courts Jurisdiction Prohibited By *Marathon*

While it is impossible to determine the precise statutory basis, if any, supporting the court of appeals' finding of core jurisdiction, the court noted two provisions in particular: 28 U.S.C. §157(b)(2)(A) ("matters concerning the administration of the estate") and § 157(b)(2)(O) ("other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor . . . relationship"). App., *infra*, 10a.[7] Even if Southmark's claims

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[7] The court also mentioned in passing § 157(b)(2)(B), although it mistakenly cited the provision as § 157(2)(B). App., *infra*, 14a. In any event, the section

arguably fall within either of these provisions, the statute cannot be construed to grant Article I courts jurisdiction denied them under the Constitution.

In *Granfinanciera,* 492 U.S. 33, this Court held that a defendant sued by the bankruptcy trustee for a fraudulent conveyance was entitled to a jury trial, even though Congress—in the same section at issue here—had classified suits involving fraudulent conveyances as core proceedings that could be adjudicated by bankruptcy judges. *See* 28 U.S.C. § 157(b)(2)(H). The Court explained that Congress impermissibly "reclassified a preexisting, common-law cause of action that was not integrally related to the reformation of debtor-creditor relations." 492 U.S. at 60. "This purely taxonomic change," the Court concluded, "cannot alter our Seventh Amendment analysis." *Id* at 61. Here, just as in *Granfinanciera*, the jurisdictional provisions of the Bankruptcy Code cannot be construed to dilute a constitutional mandate.

In fact, courts across the country have recognized that a straightforward interpretation of subsections (A) and (O) would violate this Court's holding in *Marathon* because the provisions would enable bankruptcy courts to decide the very type of disputes, such as breach-of-contract claims, considered in *Marathon* itself. These courts have therefore ignored or constricted these two sections when considering a challenge to core jurisdiction. *See, e.g., Piombo Corp. v. Castlerock Props. (In re*

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is inapplicable here, in that it extends core jurisdiction to "allowance or disallowance of claims against the estate."

Castlerock Props.), 781 F.2d 159, 162 (9th Cir. 1986) (holding that state-law contract claims are non-core proceedings even if they fit within subsections (A) or (O) because "[t]o hold otherwise would allow the bankruptcy court to enter final judgments that this court has held unconstitutional"); *Helmer v. Murray (In re Murray)*, 149 B.R. 383, 386 (E.D. Va. 1993) ("Although Section 157(b)(2) was meant by Congress to be a non-exclusive list of what might be included in the term 'core' proceedings, this court does not believe the sections or categories should be interpreted or expanded so as to in effect emasculate the jurisdictional proscriptions of the *Marathon* case.") (citation omitted); *Satelco, Inc. v. North Am. Publishers, Inc. (In re Satelco, Inc.)*, 58 B.R. 781, 788 (Bankr. N.D. Tex. 1986) ("The courts are . . . placed squarely between the constitutionally permissible jurisdictional parameters for Article I courts prescribed by the Supreme Court, and the apparent liberality of the subsequent Congressional enactment."). *See also In re Robert D. Johnson*, 960 F.2d 396, 401 (4th Cir. 1992) ("[W]e find it unnecessary to resort to this broad language [of subsections (A) and (O)] and thus risk exceeding the constitutional limitations of *Marathon*.").

The Fifth Circuit's interpretation of Section 157 amounts to a resurrection and reinstatement of the unconstitutionally broad jurisdictional provisions of the 1978 Code, which permitted bankruptcy courts to decide all matters relating to a bankruptcy proceeding. By empowering a bankruptcy judge to decide matters committed under the Constitution to an Article III tribunal, the decision below endangers the separation of powers and compels review by this Court.

II. Review Is Necessary To Resolve Conflicts Among The Courts Of Appeals And To Dispel The Lower Courts' Confusion Over The Scope Of Core Jurisdiction

Review of the decision below is further warranted to clarify the scope of core jurisdiction in light of *Marathon* and the bankruptcy statute enacted in *Marathon*'s wake. Confusion over what claims fall within the core of the federal bankruptcy power has split the circuits on a series of important and recurring issues. As the Third Circuit aptly recognized, "Bankruptcy Court jurisdiction has been the subject of heated controversy in recent decades." *Halper v. Halper*, 164 F.3d 830, 835 (3d Cir. 1999).

Foremost among these splits is the question squarely presented by this case: whether a state-law claim against a court-appointed professional constitutes a core proceeding. The decision of the court below stands in stark conflict with the Ninth Circuit's decision in *Taxel v. Electronic Sports Research (In re Cinematronics, Inc.)*, 916 F.2d 1444 (9th Cir. 1990), and the Third Circuit's decision in *Torkelson v. Maggio (In re Guild and Gallery Plus, Inc.)*, 72 F.3d 1171 (3d Cir. 1996).

In *Cinematronics*, the Chapter 11 trustee and the debtor's president (who served with court approval) were sued under a variety of state-law theories, including breach of contract, breach of fiduciary duty and fraud for conduct that occurred post-petition. 916 F.2d at 1447. The court held that the proceeding was non-core, rejecting the view that "claims arising from conduct connected with the estate after the Chapter 11 petition is filed concern the administration of the estate and qualify as core matters." *Id.* at 1450. The court reasoned that "[a] judgment against [the defendant] would not directly

determine or adjust the relationship of the . . . estate to its creditors," nor would the claims "directly affect the estate or the confirmation of the estate's plan." *Id.* In *Guild and Gallery*, the Third Circuit reached the same conclusion. There, the court held that negligence and conversion claims against a Chapter 7 trustee were non-core, noting that the plaintiff's "state law claims are not comparable to the filing of a proof of claim or raising an objection to a discharge of a particular debt." 72 F.3d at 1178. The court further noted that the plaintiff's claims "certainly could exist outside of bankruptcy [and] could all be filed in a state court." *Id.* Moreover, the claims did not "invoke[ ] a substantive right provided by title 11." *Id.* (citation omitted).

Many other conflicts flow from the uncertainty generated by *Marathon*. For example, courts have disagreed over whether an action to recover attorneys' fees under various federal fee-shifting statutes is core, *compare, e.g., Gower v. Farmers Home Admin. (In re Davis)*, 899 F.2d 1136, 1138-39 (11th Cir. 1990), *with, e.g., United States v. Yochum (In re Yochum)*, 89 F.3d 661, 670 (9th Cir. 1996); and whether proceedings to assume or reject an executory contract or an unexpired lease under 11 U.S.C. § 365 are core, *compare, e.g., Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1208 (7th Cir. 1984), *with, e.g., Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1102 (2d Cir. 1993). *See generally* Susan Block-Lieb, *The Costs of a Non-Article III Bankruptcy Court System*, 72 AM. BANKR. L.J. 529, 550 (1998) (noting abundance of circuit splits concerning definition of "core proceeding").

As the foregoing discussion makes clear, the circuits are in a terrible state of confusion over how

to determine whether a claim falls within the core of bankruptcy jurisdiction. The conflicts will only worsen as new causes of action are reviewed and classified by courts uncertain over Article III's scope. This Court should grant review to resolve this important question and clarify the bounds of core jurisdiction.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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April 12, 1999.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 96-10320

In The Matter of:
SOUTHMARK CORPORATION,

Debtor.

SOUTHMARK CORPORATION,

Appellant,

versus

COOPERS & LYBRAND;
THOMPSON & KNIGHT,

Appellees.

Appeal from the United States District Court
for the Northern District of Texas

[FILED Jan. 11, 1999]

Before JOLLY, JONES, and PARKER, Circuit Judges.

EDITH H. JONES, Circuit Judge:

This appeal arises from a malpractice suit filed by Southmark Corporation ("Southmark") against Coopers & Lybrand L.L.P. ("Coopers"), the

accountant to the court-appointed Examiner in Southmark's reorganization case under Chapter 11 of the Bankruptcy Code. Southmark filed suit in a Texas state court in April, 1995. Coopers removed the case to the bankruptcy court that had presided over Southmark's reorganization. In an unusual twist, Southmark did not perceive the bankruptcy court as a beneficial forum, so it moved for the court's mandatory abstention, or alternatively, for discretionary abstention or remand. 11 U.S.C. §§ 1334(c) (1984). Coopers sought summary judgment, a motion the bankruptcy court granted while denying Southmark's challenges to the forum. On appeal, the district court affirmed. We hold that the state-law malpractice claim is a "core proceeding" in bankruptcy and that the bankruptcy court's earlier ruling requiring Coopers to disgorge part of its fees for breach of bankruptcy disclosure rules gives rise to issue preclusion but not necessarily to claim preclusion.

I. BACKGROUND

Southmark Corporation was a real estate investment trust that sponsored private and publicly syndicated real estate partnerships during the early 1980's. From 1982 until 1989 (shortly before Southmark declared bankruptcy), Drexel Burnham Lambert, Inc. ("Drexel") served as Southmark's primary investment banker, underwriter, securities broker and investment and financial advisor. Drexel was the underwriter for various Southmark offerings of junk bonds and preferred stock, totaling more than $1 billion.

During this period, Drexel was ostensibly underwriting high-yield bond issues for companies with the understanding that the companies would use the proceeds to purchase high-yield bonds from

other Drexel clients. Southmark became involved in the Drexel scheme. In October, 1986, Southmark issued $400 million in junk bonds and $100 million in preferred stock and subsequently invested the bond proceeds and part of the preferred stock revenues in other junk bond securities.

As with many speculative ventures in the 1980's, the expanding balloon eventually burst. In April 1989, Southmark announced a $1 billion write-down of its asset values, wiping out shareholders' equity. A few months later, Southmark filed for Chapter 11 bankruptcy protection. Eventually, the holders of Southmark's public debt received approximately 5 cents on the dollar in cash and securities in the reorganized Southmark that were projected at the time to be worth as much as 13 cents on the dollar.

Shortly after filing bankruptcy, Southmark requested the appointment of an Examiner to provide an unbiased, independent assessment of the propriety and practicality of pursuing litigation against third-parties. The court-appointed Examiner applied to the bankruptcy court to retain Coopers as the Examiner's accountant. Coopers was expressly directed by the court to investigate, among other things, Drexel's dealings with Southmark. Coopers disclosed at the time of its retention that it did some accounting work for Drexel, but the firm failed to disclose either the kind and degree of work it did for Drexel, or that Coopers did substantial auditing work for Drexel.

Drexel's parent company, reeling from reverses in the junk-bond market, filed bankruptcy in February 1990. Southmark alleges that Coopers did not satisfactorily investigate Drexel's exposure to claims based upon Southmark's ill-fated junk bond investments. A Coopers employee charged that he

was removed from this aspect of the Southmark account when he recommended investigating claims against Drexel to his superiors and was ordered to desist because (unbeknownst to Southmark) Drexel was one of Coopers' largest accounting clients. In the end, Coopers submitted a report to Southmark that downplayed the viability of these particular claims against Drexel. Southmark elected not to pursue these claims by filing a timely proof of claim in the Drexel bankruptcy case.

Instead, Southmark focused its limited resources on seeking recovery against Michael Milken, the mastermind behind Drexel's junk bond operation, who, unlike Drexel, had not filed bankruptcy. Southmark developed claims against Milken that it asserts are identical to the claims it could have raised against Drexel if Coopers had completed its investigation. Southmark eventually reached a settlement agreement that could yield more than $20 million from the Milken settlement fund.

II. PROCEDURAL HISTORY

In April 1993, Galbally, then a Coopers employee, met with Southmark's general counsel and alleged that Coopers had thwarted his efforts to investigate the Drexel claims. Southmark thereupon filed a disgorgement motion in the bankruptcy court pursuant to FED. R. CIV. P. 60(b) and Bankruptcy Rule 9024, seeking reconsideration of the court's previous award of fees to Coopers for its work as the Southmark Examiner's accountant. After extensive discovery, briefing, and a hearing, the bankruptcy court awarded Southmark $585,042.48 in recovery from Coopers in a modified final order entered April 4, 1995.

Three days later, Southmark commenced the instant case in a Texas state court, alleging that Coopers held back from a full investigation of certain potential claims by Southmark against Drexel; failed to disclose this omission; and misrepresented its investigative efforts because Drexel was a large audit client of Coopers. Additionally, Southmark alleged that Coopers' failure to investigate deterred Southmark from pursuing potential claims against Drexel or filing a proof of claim in the Drexel bankruptcy. Southmark's state law causes of action for breach of contract, fraud, breach of fiduciary duty and negligent misrepresentation alleged that Coopers' conduct caused it to suffer damages, including the total fees it paid Coopers during its bankruptcy case and the amounts it would have recovered on timely claims against Drexel.

Coopers answered the state court petition and then removed the case to the federal district court, which referred the action to the same bankruptcy court that had conducted Southmark's bankruptcy and the disgorgement proceeding.[1] Southmark filed a motion for mandatory abstention, or, in the alternative discretionary abstention or remand based in part on the argument that the state law action was a non-core proceeding and therefore, abstention was required under 28 U.S.C. § 1334(c)(2). Coopers moved for summary judgment. The bankruptcy court granted Coopers' motion and dismissed the action as barred by both collateral estoppel and res judicata; the court denied Southmark's abstention

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[1] Along the way, Coopers joined Southmark's former general counsel as a third-party defendant.

motion as moot without expressly addressing its merits.

On appeal by Southmark, the district court affirmed. Announcing its reasoning in open court, the district court found that Southmark's action presented a core proceeding and that the bankruptcy court had implicitly so found in its earlier order, and he affirmed the bankruptcy court's findings regarding preclusion. Southmark has appealed.

III. ANALYSIS

No factual findings of the bankruptcy court are contested on appeal. The conclusions of law of both the bankruptcy and district court are subject to *de novo* review. *Criswell v. Hensley*, 102 F.3d 1411, 1414 (5th Cir. 1997)

A. Southmark's Motion to Abstain

Lurking like a troll beneath a bridge, procedural complexities bedevil a straight path to analysis of this case. That the bankruptcy court has some kind of jurisdiction over this malpractice action against court-appointed professionals is not in doubt. But what the court can do with its jurisdiction depends first on whether the malpractice case is a "core" bankruptcy matter or one that is "related to" Southmark's reorganization case. If the suit against Coopers is merely "related to" bankruptcy, the bankruptcy court was required to abstain from hearing it. 28 U.S.C. § 1334(c)(2).[2] If, however,

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[2] The parties do not dispute that additional statutory criteria for mandatory abstention are met here. Those criteria include a state-law cause of action, no other basis for federal court jurisdiction, and the pendency of

the controversy lies "at the core of the federal bankruptcy power," *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71, 102 S. Ct. 2858, 2870-71 (1982), the bankruptcy law permits but does not require abstention. 28 U.S.C. § 1334(c)(1).[3] The root issue is as simple -- and complex -- as that.

Three procedural obstacles must be cleared before the merits discussion can proceed. First, although this court may review the bankruptcy court's decision not to abstain, our jurisdiction is an historical anomaly. For bankruptcy cases commenced after the 1994 amendments to the bankruptcy law, decisions either to abstain or not to abstain are not, with very limited exceptions, reviewable on appeal.[4] Southmark's case predates this amendment and was filed when decisions not to abstain were reviewable on appeal.[5] The standard

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state court litigation that can timely adjudicate the claim. *See* 28 U.S.C. § 1334(c)(2).

[3] A court may discretionarily "abstain from hearing state law claims whenever appropriate 'in the interest of justice, or . . . comity with state courts or respect for State law.'" *Gober v. Terra + Corp.*, 100 F.3d 1195, 1206 (5th Cir. 1996) (quoting 28 U.S.C. § 1334(c)(1)).

[4] 28 U.S.C. § 1334(d) (1994). "Any decision to abstain or not to abstain made under this subsection (other than a decision not to abstain in a proceeding described in subsection (c)(2)) is not reviewable by appeal or otherwise by the court of appeals . . . or by the Supreme Court. . . .").

[5] 28 U.S.C. § 1334(c) (2), enacted in the Bankruptcy Amendments Act of 1984, Pub. L. 98-353, July 10, 1984, 98 Stat. 333. ("Any decision to abstain made

on appeal is abuse of discretion. *In re Howe*, 913 F.2d 1138, 1143 n.6 (5th Cir. 1990).

Second, we note, only to reject out of hand, Coopers' assertion that statutory abstention does not apply to cases removed to federal court on the basis of bankruptcy jurisdiction. 28 U.S.C. § 1452. There is no textual support in the statute for this position, only a handful of bankruptcy court opinions support it, and the vast majority of courts hold otherwise.[6] We endorse the majority rule.

Third, the bankruptcy court should have decided the jurisdiction/abstention issues before reaching the preclusion issues. *Marathon Oil Co. v. Ruhrgas*, 145 F.3d 211 (5th Cir. 1998) (*en banc*), *cert. granted*, 67 U.S.L.W. 3273 (U.S. Dec. 7, 1998) (No. 98-470). Its diffidence may understandably have been related to its uncertainty whether Southmark's claims invoke core or non-core jurisdiction. But no

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under this subsection is not reviewable by appeal or otherwise."). *See* 1 Collier on Bankruptcy (15th Ed.) § 3.01, at 3-74. By negative implication, as *Collier's* notes, decisions not to abstain are reviewable on appeal. *Id.*

[6] *See In Re United States Brass Corp.*, 173 B.R. 1000, 1004 (Bankr. E.D. Tex. 1994) ("it is the majority opinion that abstention does apply to [removed] cases . . ."); *see also Robinson v. Michigan Consol. Gas Co., Inc.*, 918 F.2d 579, 584 n.3 (6th Cir. 1990); *Williams v. Shell Oil Co.*, 169 B.R. 684, 690 (S.D. Cal. 1994). *But see In re Branded Products*, 154 B.R. 936 (Bankr. W.D. Tex. 1993) (mandatory abstention is inapplicable to cases removed from state courts pursuant to 28 U.S.C. § 1452).

pussy-footing around is allowed on jurisdictional issues.

All of that said, the question is how Southmark's claims fit into bankruptcy jurisdiction. The progenitor of the current bankruptcy system is another *Marathon* case,[7] in which the Supreme Court struck down as constitutionally too far-reaching Congress's assignment of jurisdiction to non-Article III bankruptcy judges under the 1978 Bankruptcy Code. In *Marathon*, the debtor filed suit on a pre-bankruptcy state-law breach of contract claim. Justice Brennan, writing for the plurality, distinguished between "the restructuring of debtor-credit relations, which is at the core of the federal bankruptcy power" and the "adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case." 458 U.S. at 71, 102 S. Ct. at 2871. The narrowest construction of *Marathon*, that placed upon it by Chief Justice Burger's dissenting opinion, is this:

> a "traditional" state common law action, not made subject to a federal rule of decision, and related only peripherally to an adjudication of bankruptcy under federal law, must, absent the consent of the litigants, be heard by an "Art. III court" if it is to be heard by any court or agency of the United States.

Id. at 92, 102 S. Ct. 2882 (Burger, C.J., dissenting).

Congress, re-enacting bankruptcy courts' jurisdiction in the wake of *Marathon*, drew on the

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[7] *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S. Ct. 2858 (1982).

"core" terminology to describe matters or proceedings that are an integral part of the bankruptcy case. For present purposes, such core jurisdiction statutorily includes "matters concerning the administration of the estate," 28 U.S.C. § 157(b)(2)(A) and "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor ... relationship...." *Id.* at § 157(b)(2)(O). The statute also permits bankruptcy courts to hear and determine other matters that are "related to" bankruptcy but are not "core" matters subject to the ultimate authority of the district court.[8]

In this circuit, Judge Wisdom authored a significant opinion interpreting both *Marathon* and the post-*Marathon* jurisdictional amendments. *See In re Wood*, 825 F.2d 90 (5th Cir. 1987). *Wood* involved a lawsuit filed by a third-party against the debtor over shares of stock acquired by the debtor post-petition. Judge Wisdom distilled the formula for bankruptcy court jurisdiction thus:

> We hold, therefore, that a proceeding is core under section 157 if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case. The proceeding before us does not meet this

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[8] "Related-to" matters are those which, being peripheral to the concerns of the bankruptcy case and based on extrinsic sources of law, require mandatory abstention. *See* discussion *supra* note 2. The bankruptcy court may make a recommendation to the district court on the disposition of related-to matters, but it may not enter judgment concerning them unless the parties expressly so consent. 28 U.S.C. § 157(c).

> test and, accordingly, is a non-core proceeding. The plaintiff's suit is not based on any right created by the federal bankruptcy law. It is based on state created rights. Moreover, this suit is not a proceeding that could arise only in the context of a bankruptcy. It is simply a state contract action that, had there been no bankruptcy, could have proceeded in state court.

Id. at 97 (footnote omitted).

Southmark contends that its claims against Coopers do not satisfy the Wood test for core bankruptcy jurisdiction. First, Southmark's claims arise under state, not federal law and involve the company's "private rights" against Coopers rather than a "restructuring of debtor-creditor relations." Second, Southmark contends, the action against Coopers is not "a proceeding that, by its nature, could arise only in the context of the bankruptcy case." *Id.*

Although Southmark is correct in focusing attention on *Marathon*, the post-*Marathon* jurisdictional provisions, and on *Wood*, its interpretation of core bankruptcy matters is too narrow. To begin with, the state law origin of Southmark's claims is not dispositive. The jurisdictional statute expressly provides that the applicability of state law to a proceeding is insufficient in itself to render it a non-core proceeding. 28 U.S.C. § 157(b)(3). This provision, as *Wood* explains, recognizes Justice White's sensible observation in *Marathon* that many truly bankruptcy issues, like the determination of the basis for creditors' claims, turn on state law. *Wood*, 825 F.2d at 96. That Southmark's claims against the

court-appointed accountant for its examiner arose under state law does not prevent them from involving core jurisdiction.

Southmark also disputes that its claims could arise "only in the context of a bankruptcy case," inasmuch as Southmark could have sued any accounting firm that worked for it on similar grounds of disloyalty, non-disclosure and malpractice. It is somewhat disingenuous for Southmark to attempt to pry these claims out of their bankruptcy setting. Southmark's petition alleges *inter alia* claims for breaches of fiduciary duty and of the contract whose terms were approved by the bankruptcy court. Southmark prays for actual damages including return of the entire $4 million fee it paid Coopers from money belonging to the debtor's estate. The fee award was both approved by the bankruptcy court and subjected to the bankruptcy court's later disgorgement order.

In this case, the professional malpractice claims alleged against Coopers are inseparable from the bankruptcy context. A *sine qua non* in restructuring the debtor-creditor relationship is the court's ability to police the fiduciaries, whether trustees or debtors-in-possession and other court-appointed professionals, who are responsible for managing the debtor's estate in the best interest of creditors. The bankruptcy court must be able to assure itself and the creditors who rely on the process that court-approved managers of the debtor's estate are performing their work, conscientiously and cost-effectively. Bankruptcy Code provisions describe the basis for compensation, appointment and removal of court-appointed professionals, their conflict-of-interest standards, and the duties they must perform. *See*

generally 11 U.S.C. §§ 321, 322, 324, 326-331. Although standards for the conduct of court-appointed professionals, the breach of which may constitute bankruptcy malpractice, are not comprehensively expressed in the statute, the Code need not duplicate relevant, also-applicable state law. It is evident that a court-appointed professional's dereliction of duty could transgress both explicit Code responsibilities and applicable professional malpractice standards. For instance, in *Billing v. Ravin, Greenberg & Zackin, PA.*, 22 F.3d 1242 (3d Cir. 1994), the professional malpractice allegations included the attorneys' failure to comply with court orders and to submit a plan of reorganization to the bankruptcy court. Award of the professionals' fees and enforcement of the appropriate standards of conduct are inseparably related functions of bankruptcy courts.

Supervising the court-appointed professionals also bears directly on the distribution of the debtor's estate. If the estate is not marshaled and liquidated or reorganized expeditiously, there will be far less money available to pay creditors' claims. Excessive professional fees or fees charged for mediocre or, worse, phantom work also cause the estate and the creditors to suffer. Southland might retort that this concern for the general well-being of the debtor's estate is over-played -- technically, the liquidation of any claim that the debtor holds against third parties would enhance the debtor's estate as much as collection on a malpractice claim against court-appointed professionals. *Marathon* held, in fact, that a debtor's contract claim against a third party (which had not filed a claim in bankruptcy) was not within the bankruptcy court jurisdiction, even though successful prosecution of the action would enrich the debtor's estate. And in *Wood*, a dispute

over shares of stock acquired by the debtor post-petition fell only within the related-to jurisdiction but not core bankruptcy jurisdiction. These cases are, however, distinguishable from a malpractice claim involving court-appointed professionals. In the *Marathon* and *Wood* situations, the claims that were being prosecuted could stand alone from the bankruptcy case. A malpractice claim like the present one inevitably involves the nature of the services performed for the debtor's estate and the fees awarded under superintendence of the bankruptcy court; it cannot stand alone.

Even more significant, the claim against Coopers is not just for malpractice, but for the value of the asset which Coopers was to assist Southmark in recovering. If Coopers had done the job for which it was retained, according to Southmark's allegations, Southmark would have filed a claim in the Drexel bankruptcy and recovered a substantial sum for creditors. The claim against Coopers may therefore be viewed as one to recover an asset of Southmark's estate that Coopers let slip away.

From yet another perspective, this is not just a malpractice case like any other professional malpractice litigation Southmark might pursue. Instead, Coopers has filed administrative claims to obtain its fees in the bankruptcy court, and the debtor's action is similar to a counterclaim against Coopers. Unlike essential parties in *Marathon* or *Wood*, Coopers is not a stranger to the bankruptcy case, and this malpractice claim may invoke the bankruptcy court's core jurisdiction to adjudicate and determine the extent of claims by and against Southmark's estate. *See* 28 U.S.C. § 157(2)(B); *see generally Billing*, 22 F.3d 1242.

Although surprisingly few court of appeals cases have explored the boundaries of bankruptcy courts' core jurisdiction in the wake of *Marathon*, at least three decisions are premised on the understanding that professional malpractice claims against court-appointed professionals are indeed core matters. *See Billing*, 22 F.3d 1242; *Walsh v. Northwestern Nat'l Ins. Co.*, 51 F.3d 1473, 1476 (9th Cir. 1995); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 483 n.4 (6th Cir. 1992). No appeals court decision has held otherwise. In one case against a bankruptcy trustee to recover property that did not belong to the debtors' estate, the court rejected subject matter jurisdiction founded on either core or related-to-bankruptcy jurisdiction. *In re Guild and Gallery Plus, Inc.*, 72 F.3d 1171, 1173 (3d Cir. 1996).

Southmark's lawsuit draws into question Coopers' performance of its duties under court order, and it seeks in part to recover on the claim Southmark would have had against Drexel. For these and other reasons just discussed, we conclude that Southmark's case against Coopers is a core proceeding in bankruptcy. Because this is a core proceeding, the bankruptcy court had discretion whether to abstain from hearing it. We hold that the court did not abuse his discretion in declining to abstain.

B. Preclusion Issues

Southmark has already recovered damages of a sort from Coopers, in that the bankruptcy court ordered Coopers to disgorge over $550,000 of the fees it received as court-appointed examiner. The recovery, based on Coopers' failure to disclose its professional relationships with Drexel pursuant to

11 U.S.C. § 328(c), consisted of Drexel-related fees of $55,000, together with treble that amount as a penalty, plus reimbursement of Southmark's costs and attorneys fees in prosecuting the motion. Coopers asserts that this recovery, which neither party appealed, provides a basis for either issue or claim preclusion against Southmark's current lawsuit. Preclusion rules deter repetitive and piecemeal litigation by preventing the relitigation of issues that have been finally decided and the assertion of claims covering transactions that have already been disputed in court. The criteria for issue and claim preclusion are different, however and one rule may apply when the other does not. While we doubt that a basis for claim preclusion existed here, issue preclusion prevents Southmark from relitigating the cause of its failure to file a timely proof of claim in the Drexel bankruptcy.

1. Issue Preclusion

Issue preclusion, formerly known as collateral estoppel, applies when the following elements are met:

> (1) the issue at stake must be identical to the one involved in the prior action; (2) the issue must have been actually litigated in the prior action; and (3) the determination of the issue in the prior action must have been a part of the judgment in that earlier action.

Recoveredge L.P. v. Pentecost, 44 F.3d 1284, 1290 (5th Cir. 1995). Relitigation of an issue is not precluded unless the facts and the legal standard used to assess them are the same in both

proceedings. *Id.* at 1291 (citations omitted)9 The bankruptcy court and the district court found that Southmark was bound by issue preclusion from asserting that Coopers' malpractice caused Southmark to suffer damages, as that issue had already been litigated and decided in the bankruptcy court disgorgement proceeding.

Southmark first argues that the relevant issues are not identical. The disgorgement proceeding only resolved whether Coopers' failure *to disclose a conflict of interest* caused Southmark to fail to file a claim against Drexel (the bankruptcy court concluded it did not). In the instant case, Southmark alleges that Coopers's failure to *adequately investigate* the viability of a claim against Drexel caused Southmark to fail to file a timely claim.

Coopers responds that the causation of damages issue is the same in the disgorgement proceeding and the instant case. We agree. It was undisputed that Coopers did not disclose to the bankruptcy court its significant auditing relationship with Drexel. In order to gauge the penalty for nondisclosure, the bankruptcy court had to assess whether Coopers' ethical conflict, reflected in nondisclosure of the relationship and inadequate investigation of Drexel claims, led Coopers to downplay potential Southmark claims against Drexel and to discourage Southmark from pursuing its rights against Drexel.

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9 Southmark cites a fourth, "special circumstance" requirement for application of issue preclusion. *See Copeland v. Merrill Lynch & Co. Inc.*, 47 F.3d 1415 (5th Cir. 1995). If such a requirement applies in this case, a proposition we find highly questionable, Southmark has in any event failed to support it factually. *See Recoveredge*, 44 F.3d at 1290-91 n.12.

Southmark asserts that the issues are different because "Coopers could have failed to disclose its conflict of interest to the Bankruptcy Court and still could have done its job properly." This distinction is theoretically possible but inconsistent with the way in which the disgorgement proceeding was litigated. Southmark wanted the bankruptcy court to find that Coopers' overall lapses caused Southmark to fail to file a timely proof of claim, a scenario that would enhance its argument for full disgorgement of Coopers' multimillion dollar court-approved fees.[10] In contrast, to minimize the impact of its actions, Coopers contended that it did not influence Southmark's decision not to file a proof of claim against Drexel.

Regarding causation, the bankruptcy court stated that "Coopers did not cause Southmark to fail to file timely proof of claim in the Drexel bankruptcy case." As the court reasoned, the Examiner notified Southmark of the Drexel proof of claim bar date and that the Examiner would not develop the securities claims; the basis for the Drexel claim was being alluded to by the media; and Southmark had made an intentional decision to pursue other avenues with its limited resources. Near the end of the disgorgement order, the court rephrased its causation finding, noting that "the *non-disclosure* did not cause Southmark to fail to timely file a proof of claim in the Drexel case." (emphasis added). The court was not limiting the generality of its

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10 For instance, Southmark's pleadings in the disgorgement proceeding specifically state that Southmark "surely would have" filed a Drexel proof of claim had Coopers "further investigated and disclosed" theories of liability against Drexel.

earlier finding, however, for this additional finding bears on the narrow compass of a violation that the court finally found after rejecting Southmark's attack on Coopers' total fee.

The court's findings of no causation, as well as its recitation of the law applicable to disgorgement, lead us to reject Southmark's additional contention that a causation finding was not necessary. Southmark is wrong because the amount of disgorgement depended in large part on the harm done to Southmark by Coopers' ethical lapse. *See In re Kendavis Indus. Int'l., Inc.*, 91 B.R. 742, 762 (Bankr. ND. Tex. 1988). The bankruptcy court wrote that he "had to consider that [causation] issue in performing the fact-specific inquiry required by case law to determine whether a professional must disgorge fees." The bankruptcy court also wrote in ruling on issue preclusion that he would have had to reappraise the disgorgement amount if he had been convinced that Coopers' omissions caused Southmark to forfeit a significant recovery opportunity in the Drexel bankruptcy. As he observed, Southmark sought a multimillion dollar recovery from Coopers. A ruling on causation was necessary to the court's decision on the amount of disgorgement.[11]

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11 Southmark disputes the bankruptcy court's discretion to award a sliding-scale disgorgement, and hence to consider causation of damages. The company is apparently persisting in its earlier contention in the disgorgement proceeding that a violation of § 328(c) requires restitution of all fees received by the professional firm. But having lost and not appealed the bankruptcy court's failure to order complete disgorgement, Southmark cannot now ignore the court's fact-specific ruling.

Southmark finally urges that causation was not actually litigated in the disgorgement proceeding. After a careful review of the record and the bankruptcy court's rulings, we cannot accept this contention. Southmark sought full return of Coopers' accounting fees in the disgorgement proceeding, while Coopers parried by arguing that it should not have to return fees for valuable services rendered in aspects of the bankruptcy other than the Drexel claims and by denying that its breaches caused Southmark's non-filing of a Drexel claim. The court balanced the facts and equities, finally arriving at a disgorgement penalty that quadrupled the amount of fees Coopers charged on Drexel matters but rejected both the complete restitution of fees sought by Southmark and restitution based on any causal connection between Coopers' actions and Southmark's failure to file a claim against Drexel.

The three criteria for issue preclusion accordingly have been satisfied on the causation of Southmark's damages with respect to the Drexel bankruptcy.

2. Claim Preclusion

Although issue preclusion prevents Southmark's attempt to relitigate a critical issue against Coopers, we must briefly distinguish that result from the lower courts' rather perfunctory reliance on claim preclusion. Claim preclusion,[12] or *res judicata*,

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12 Coopers did not raise res judicata as a defense once the case was removed to bankruptcy court. Generally speaking, pursuant to Fed. R. Civ. P. 8(c), res judicata is an affirmative defense and should not be raised *sua sponte*. *Carbonell v. Louisiana Dept. of*

bars the litigation of claims that either have been litigated or should have been raised in an earlier suit. *Super Van Inc. v. San Antonio*, 92 F.3d 366, 370 (5th Cir. 1996). The test for claim preclusion has four elements:

> (1) The parties are identical or in privity; (2) the judgment in the prior action was rendered by a court of competent jurisdiction; (3) the prior action was concluded to a final judgment on the merits; and (4) the same claim or cause of action was involved in both actions.

Swate v. Hartwell, 99 F.3d 1282, 1286 (5th Cir. 1996).

To determine whether two suits involve the same claim under the fourth element, this court has adopted the transactional test of the Restatement (Second) of Judgments, § 24. *Southmark Properties v. Charles House Corp.*, 742 F.2d 862 870-71 (5th Cir. 1984). Thus, the critical issue is whether the two actions under consideration are based on "the same nucleus of operative facts." *In re Baudoin*, 981 F.2d 736, 743 (5th Cir. 1993) (*quoting In re Howe*, 913 F.2d 1138, 1144 (5th Cir. 1990). In the instant case, the bankruptcy court found that the disgorgement proceeding and this action involved the "same nucleus of operative facts;" indeed, this action was "litigation resulting from a single

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Health & Human Resources, 772 F.2d 185, 189 (5th Cir. 1985). Without considering whether any exceptions to this rule apply in this case, this court simply notes that Southmark failed to complain of this omission on appeal, and thus, waived any objections to the bankruptcy court's *sua sponte* consideration of res judicata.

transaction with different forms of relief being requested." The court also observed that Southmark could have raised its present claims when it originally sought disgorgement of Coopers' fees: to the extent any of Southmark's claims were non-core, the district court could have adopted the bankruptcy court's findings of law and fact or withdrawn the order of reference.

Southmark asserts that the bankruptcy court erred in finding claim preclusion because disciplinary measures pursuant to procedural rules do not have preclusive effect on subsequent substantive claims. Southmark cites *Cohen v. Lupo*, 927 F.2d 363, 365 (8th Cir. 1991), which held that the tort of malicious prosecution and a Rule 11 disciplinary proceeding "differ in their nature, the elements of the claims, and the potential remedies."[13] By analogy, Southmark contends that a disgorgement proceeding pursuant to 11 U.S.C. § 328(c) should similarly not bar subsequent substantive claims, as it is essentially a remedial penalty provision. *See, e.g., Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994) (citing legislative history for the proposition that § 328(c) "authorizes a 'penalty' for failing to avoid a disqualifying conflict of interest").

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13 *See also Lightning Lube, Inc. v. Whitco Corp.*, 4 F.3d 1153, 1196 (3d Cir. 1993) ("the denial of a Rule 11 motion does not foreclose the assertion of a subsequent malicious prosecution suit. . . ."); *cf. Port Drum Co. v. Umphrey*, 852 F.2d 148, 150 (5th Cir. 1988) ("If Rule 11 did expand substantive rights, it would be invalid under the Enabling Act" because it regulates procedure rather than create a new substantive right or an independent cause of action).

Southmark has expressed an important insight, but we believe the roots of the claim preclusion problem lie deeper than the distinction between an ancillary penalty proceeding (*e.g.* Rule 11 or disgorgement) and a substantive cause of action. While this court has held that claim preclusion applies only to core proceedings in bankruptcy,[14] we have not determined that it applies to all core proceedings. Thus, we have held that claim preclusion does not apply where, because of bankruptcy's truncated procedures on motions to lift stay, lender liability claims could not have been brought and litigated in the earlier proceeding. D-1 *Enterps., Inc. v, Commercial State Bank*, 864 F.2d 36, 38-39 (5th Cir. 1989).[15] Whether the non-trial-type procedures utilized in the bankruptcy court to decide the disgorgement proceeding, of the unavailability of a jury trial,[16] or both circumstances may have meant that Southmark's state-law claims

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14 *Howell Hydrocarbons, Inc. v. Adams*, 897 F.2d 183, 189 (5th Cir. 1990).

15 *See also In re Howe*, 913 F.2d at 1143-47 (holding that claims raised in later litigation were barred because they could have been fully litigated in Chapter 11 reorganization process).

16 We have also held that a debtor does not waive the right to a jury trial by filing a voluntary bankruptcy case. *In re Jensen*, 946 F.2d 369 (5th Cir. 1991); *but cf. Billing*, 22 F.3d at 1242-54 (holding that debtors have no right to jury trial on malpractice claims against their attorneys); *Id.* at 1254-1260 (Sloviter, C.J., dissenting). The authority of a bankruptcy court to hold a jury trial, in cases like this, before the 1994 amendment to U.S.C. § 157(e), was in great doubt. *See* 1 Collier on Bankruptcy 15th Edition Revised ¶ 3.08 (1998).

against Coopers could not have been litigated, or litigated effectively, before the bankruptcy court in the earlier proceeding, is an interesting question. *Cf. In re Howe*, 913 F.2d at 1146. We will not speculate on complications arising from the additional possibility, mentioned by the bankruptcy court, that if Southmark had filed its malpractice action together with the motion to disgorge fees, the bankruptcy court could have heard both matters pursuant to a referral from the district court. Enough has been said to dispel the notion that claim preclusion is obviously applicable here.

CONCLUSION

Based on the foregoing discussion, we hold that the bankruptcy court had core jurisdiction over this case; that it did not abuse its discretion by refusing to remand; and that Southmark was precluded from relitigating the finding that Coopers did not cause it to fail to file a timely claim in the Drexel bankruptcy.

AFFIRMED.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	*	
SOUTHMARK	*	
CORPORATION,	*	
Debtor	*	Civil No. 3:95-CV-2193-H
	*	Bank. No. 389-36324-SAF-11
SOUTHMARK	*	
CORPORATION	*	
Appellant	*	
	*	
v.	*	
	*	
COOPERS &	*	
LYBRAND, LLP	*	
Appellee	*	

ORDER

[FILED April 15, 1996]

On February 27, 1996, the Court heard argument on Appellant Southmark Corporation's Brief, filed October 17, 1995; Appellee Coopers & Lybrand, L.L.P.'s Brief, filed November 1, 1995; and Appellant Southmark Corporation's Reply Brief, filed November 13, 1995.

After considering the pleadings, the relevant authorities, and the argument and representations of counsel, the Court was of the opinion, for reasons stated in open court, that Appellant Southmark Corporation's Appeal should be, and it was, DENIED.

Accordingly, the decision of the Bankruptcy Court is AFFIRMED.

SO ORDERED.

DATED: February 27, 1996.

/s/
BAREFOOT SANDERS, JUDGE
UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	(	
SOUTHMARK	(	
CORPORATION	(	CIVIL ACTION NUMBER
	(	
SOUTHMARK	(	
CORP.	(	
	(	
VERSUS	(	3:95-CV-2193-H NUMBER
	(	
COOPERS &	(	
LYBRAND, LLP	(	February 27th, 1996

TRANSCRIPT OF ORAL ARGUMENT
BEFORE
THE HONORABLE BAREFOOT SANDERS
UNITED STATES DISTRICT JUDGE

[FILED March 1, 1996]

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PAMELA J. WILSON, C.S.R.,
U.S. DISTRICT COURT

Billing court -- the Billing court would have said this is not a core matter and there is no doubt that the Fifth Circuit if applies this test would hold the same way.

Thank you, Your Honor.

THE COURT: Thank you.

I will then address the matter at this time.

I'll start with the proposition which y'all are aware that findings of fact are subject to the clearly erroneous standard that the conclusions of law are reviewed de novo and there's not much point in dwelling on that.

It seems to me that the key issue here from which everything else proceeds is whether or not we are dealing with a core proceeding. And in making that decision I note that counsel dwelt a deal on the billings case. The court by necessity has reviewed also the Wood case, which controls in this circuit; the Marathon Pipeline case, which is a celebrated case in several ways; and the Sibarium case, which I handled here some years ago.

The question essentially it seems to me -- and I'm -- not being full-time bankruptcy, I'm sometimes inclined to think we dwell more on semantics than perhaps we should in a bankruptcy. But the question is whether or not the claims that are being asserted by Southmark in the removed case are, "inextricably linked" to the underlying bankruptcy.

To fit it into the Wood test, is the claim or the proceeding one that would arise only in bankruptcy. It's a little bit broader test than what I put forth in Sibarium, but it seems to me it can be harmonized.

My conclusion is that this is a core claim. It arose postpetition. It is not independent of the underlying bankruptcy. In fact, it seems to me almost totally dependent on it.

There are other cases, obviously. In the Citizen Bank and Trust Company case, which pointed out that claims that are independent or antecedent to the bankruptcy proceeding are more likely to be noncore. This does not fit in that suit of clothes.

Stockard Flying Service, 74 B.R. 704 out of the Northern District of Indiana, seems somewhat close to this. And it brings me to the conclusion that this is core.

The Solar King case out of the Western District of Texas, 142 B.R. 772, relates directly and it argues that this is core.

SPI Communications and Marketing, Inc., out of the Northern District of New York would support the conclusion that it's core.

And, of course, there are other cases. And I understand there are cases the other way.

But what it boils down to for me is that all of the Southmark claims here and the facts supporting those claims arise from duties allegedly owed by Coopers and from Coopers alleged breach of those duties during the bankruptcy case.

And, therefore, the claims are core.

Being core, mandatory abstention is not required.

I may miss the point, but it seems a little too technical, for my taste at least, to say that because Judge Felsenthal did not recite the catechism about decided not to abstain that he therefore missed his opportunity entirely. I think it's implicit in what

Judge Felsenthal ruled that he effectively decided not to abstain.

And I turn next to whether to apply res judicata. I think res judicata can be raised sua sponte. There are a number of cases cited in the briefs which I reviewed. If there's any problem about 56(c) -- application of 56(c), I think it was harmless.

The disputed element here as to whether or not the elements are res judicata are present, the only disputed element, and I think counsel have agreed on that, that there is one disputed element, and that is, whether both suits involve the same kind of claim and the same kind of facts. Now, there may be a little bit different kind of claim, but the underlying facts that are asserted are the same.

The other criteria of res judicata are met.

Here I find and conclude that the underlying facts and the disgorgement motion in the underlying proceeding, that is the bankruptcy court, related to whether Coopers alleged nondisclosure about the Drexel bankruptcy was improper. Those same facts are relied on in the lawsuit which has been removed here from the state court. And this seems to me to be -- lead to the conclusion that that one disputed element of res judicata is met and the rest not being contested that res judicata does apply here.

As to whether or not collateral estoppel need to be addressed, I don't really think it does. I will address it, nevertheless, that is: Was the issue here litigated and was the determination of the issue in the prior action necessary to the judgment?

It seems clear to me that causation was actually litigated in the bankruptcy court and the bankruptcy action. And, in fact, on the pretrial order on

appellant's disgorgement motion a contested issue of fact addressed the issue of causation.

I understand there is a recent case, out of the District of Colombia, the Henry case, counsel I think may have alluded to that, raising a question as to whether causation is a necessary element. That's not the law in the Fifth Circuit as I read it. It certainly was not the law when Judge Felsenthal ruled.

I think there might be, if we decided to get right down to it, a question as to whether or not that having been cause -- causation having been inserted into the pretrial order as a contested issue of fact, whether it waived any complaint that the appellant might make about causation being necessary to the judgment of the original bankruptcy court.

I therefore, to sum up, find: One, that it's a core case; second, that Judge Felsenthal decided not to abstain, effectively did so, and that he was correct; that res judicata may be raised sua sponte and was nothing improper about that; that res judicata applies here; and that the doctrine covers the disputed issue here and in effect eviscerates Southmark's claims in the bankruptcy court; and even if collateral estoppel were necessary to be applied, that collateral estoppel would also require affirmance of the bankruptcy court's ruling.

So the judgment of the bankruptcy court will be affirmed.

I appreciate counsel's good presentation.

We'll be in recess.

(Recess taken.)

IN THE
UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE: SOUTHMARK CORPORATION, DEBTOR.	§	CASE NO. 389-36324-SAF-11
SOUTHMARK CORPORATION, PLAINTIFF, VS. COOPERS & LYBRAND, L.L.P., DEFENDANT.	§	ADVERSARY NO. 395-3205
COOPERS & LYBRAND, L.L.P., THIRD-PARTY PLAINTIFF, VS. CHARLES B. BREWER, and THOMPSON & KNIGHT, L.L.P., THIRD-PARTY DEFENDANTS.	§	

MEMORANDUM OPINION AND ORDER

[ENTERED August 15, 1996]

Coopers & Lybrand, L.L.P., moves the court for a judgment on the pleadings dismissing this adversary proceeding. Southmark Corporation moves the court to stay its consideration of that motion pending Southmark's motion for abstention or, in the alternative, remand the complaint to the state court. The third party defendants, Charles B. Brewer and Thompson & Knight, L.L.P., move the court to dismiss the third party complaint. The court conducted a hearing on these motions on July 28, 1995.

Because Cooper & Lybrand's motion for a judgment on the pleadings is dispositive, the court only addresses that motion. The motion and response focus on collateral estoppel, specifically addressing the issue of causation. The hearing however also covered the elements of res judicata.

Southmark filed its petition for relief under Chapter 11 of the Bankruptcy Code on July 14, 1989. By order entered September 8, 1989, the bankruptcy court directed that the United States Trustee appoint an examiner. By order entered October 30, 1989, the court conditionally approved the employment by the examiner of Coopers & Lybrand as his accountants. By order dated February 1, 1990, the court confirmed the approval of the examiner's retention of Coopers & Lybrand, effective as of September 26, 1989. *In re Southmark*, 113 B.R. 280, 284 (Bankr. N.D. Tex. 1990).

The court conducted a hearing on Coopers' application for final allowance of compensation and

reimbursement of expenses on November 14, 1990. The court entered its final order on that matter on March 5, 1991.

On January 4, 1994, Southmark filed a motion to reconsider the order awarding Coopers' final compensation. In its motion, filed under Bankruptcy Rule 9024, Southmark complained about Coopers' failures to disclose fully its relationship with Drexel Burnham Lambert, alleging that Coopers did not disclose a decision not to pursue an investigation of certain issues pertaining to Drexel's transactions with Southmark. Southmark further alleged that as a result of the alleged non-disclosure, Southmark ultimately failed to timely file a proof of claim in the Drexel bankruptcy case, costing Southmark a significant dividend from the Drexel bankruptcy estate.

The Rule 9024 motion sought a disgorgement of Coopers' fees, with Southmark contending that Coopers was not disinterested and that Coopers held an interest adverse to the Southmark estate. The motion invoked Fed. R. Civ. P. 60(b)(6), fraud on the court.

Coopers filed a response to the motion. The court held a status conference on the motion at which time the court agreed to conduct a Fed. R. Civ. P. 12(b)(6)-type analysis. The parties submitted written arguments. The parties argued whether Southmark's motion would be governed by Rule 60(b)(3); covering fraud, misrepresentation and other misconduct of an adverse party. The court entered an order on June 6, 1994, denying Southmark's motion based on Rules 60(b)(2) and (3), but continuing the matter as to Rule 60(b)(6). Also on June 6, 1994, the court entered a scheduling

order setting an evidentiary hearing on the merits of the motion.

The parties submitted a joint pretrial order. The court conducted an evidentiary hearing on December 20, 1994. With the pre-hearing motions, scheduling order and the pretrial order, the motion proceeded as if the court had formally applied the adversary proceeding rules. Bankruptcy Rule 9014. The court entered its memorandum opinion and order on March 1, 1995. On April 4, 1995, the court entered a judgment modifying final order directing that Southmark recover $585,042.48 from Coopers plus post-judgment interest allowed by Title 28 of the United States Code. Neither party appealed the order or judgment. Coopers paid Southmark the amount of the judgment.

To determine the amount of the judgment, the court had to engage in a fact specific inquiry. In doing so, the court specifically found that "Coopers did not cause Southmark to fail to file timely proof of claim in the Drexel bankruptcy case." The court also found "While the non-disclosure did not cause Southmark to fail to timely file a proof of claim in the Drexel case, the non-disclosure impeded the court's function to assure the integrity of an investigation by professional persons with undivided loyalty."

On April 7, 1995, Southmark commenced this action against Coopers in the 134th Judicial District Court, Dallas County, Texas. On May 8, 1995, Coopers filed its answer and affirmative defenses. On May 15, 1995, Coopers filed a notice of removal to this court.

Southmark's complaint is premised on the same factual allegations as its earlier Rule 9024 motion.

On those factual allegations, Southmark alleges claims for relief based on breach of contract, fraud and deceit, breach of fiduciary duty and negligent misrepresentation. Southmark seeks recovery of compensatory damages allegedly caused by Coopers' conduct, and exemplary damages, attorneys fees and pre- and post-judgment interest. Southmark premises its damages on the failure to file a proof of claim in the Drexel bankruptcy case.

Three requirements must be met to apply collateral estoppel. Coopers must establish that (1) the issue at stake must be identical to the one involved in the prior action; (2) the issue must have been actually litigated in the prior action; and (3) the determination of the issue in the prior action must have been a necessary part of the judgment in that earlier action. *Recoveredge L.P. v. Pentecost*, 44 F.3d 1284, 1290 (5th Cir. 1995).

Coopers conduct is identical. Southmark's conduct is identical. From that conduct, on the Rule 9024 motion Coopers submitted the contested fact to the court of "Whether any damages to Southmark as a result of its failure to assert timely claims against Drexel were caused by the act or omission of any person other than Southmark itself." Joint Pretrial Order, p. 17. The parties actually litigated that issue. The court had to consider that issue in performing the fact-specific inquiry required by case law to determine whether a professional must disgorge fees. The court could not have decided the disgorgement issue without deciding that damages causation issue. Indeed, had the court found that Coopers caused Southmark to fail to timely file the Drexel proof of claim, the disgorgement judgment necessarily would have been different. Southmark sought a multi-million dollar recovery on its

contention that Coopers caused the failure to file the proof of claim. The court necessarily had to decide the causation issue to decide the Rule 9024 motion.

Southmark now alleges breach of contract, fraud and deceit, breach of fiduciary duty and negligent misrepresentation. To recover damages on any or all of those claims, Southmark would have to establish that Coopers caused Southmark to fail to file the Drexel proof of claim, resulting in Southmark's damages. This court has already found, after a fully litigated evidentiary hearing involving both parties, that Coopers did not cause Southmark to fail to file timely the proof of claim. Coopers therefore did not cause Southmark to suffer the damages from Southmark's failure to recover a dividend in the Drexel case.

The legal standards must be the same. The causation of damages element considered for the Rule 9024 motion disgorgement analysis is the same causation of damages element in each of the claims now being asserted. *See Recoveredge*, 44 F.3d at 1294. Southmark contends, however, that it had a greater burden of proof in the prior proceeding than in this proceeding. Southmark's written papers in the prior proceeding did not urge the court to apply a clear and convincing burden of proof for causation of damages. Coopers did not urge that standard, either. Southmark does not present authority that after *Grogan v. Garner*, 498 U.S. 279, 286 (1991), the burden of proof should not be preponderance of the evidence. The same legal standards apply.

Application of the collateral estoppel doctrine results in Southmark's inability to establish a necessary element for recovery under any and all of its alleged claims. The motion for a judgment on the pleadings must be granted.

Four requirements must be met to apply res judicata: (1) the parties must be identical in both suits; (2) the prior judgment must have been rendered by a court of competent jurisdiction; (3) there must be a final judgment on the merits; and (4) the same cause of action must be involved in both cases. *Matter of Baudoin*, 981 F.2d 736, 740 (5th Cir. 1993).

The parties to the complaint are the identical parties to the Rule 9024 motion. A final judgment has been entered in the Rule 9024 matter. Indeed that judgment has been paid.

The causes of action in this adversary proceeding are the same as in the Rule 9024 motion. Federal law determines the preclusive effect of a prior federal judgment. The Fifth Circuit has "adopted a transactional test for determining whether two complaints involve the same cause of action. Under this approach, the critical issue is not the relief requested or the theory asserted but whether the plaintiff bases the two actions on the same nucleus of operative facts. If the factual scenario of the two actions parallel, the same cause of action [is] involved in both. The substantive theories advanced, forms of relief requested, types of rights asserted, and variations in evidence needed do not inform this inquiry." *Agrilectric Power Partners, Ltd. v. General Electric Co.*, 20 F.3d 663, 665 (5th Cir. 1994).

The two matters present the same factual scenario. The two present the same nucleus of operative facts. The same causes of action are therefore involved in this complaint and the prior Rule 9024 motion between the parties.

The final inquiry involves whether the prior judgment was rendered by a court of competent jurisdiction. The parties do not contend otherwise. This court had jurisdiction to enter the judgment on the Rule 9024 motion.

Of course, the inquiry must go further. *See Baudoin*, 981 F.2d at 740-744. This court has jurisdiction over this adversary proceeding. 28 U.S.C. §§157 and 1334(b). Neither party contends otherwise. However, Southmark contends that the complaint raises non-core matters. Coopers argues that the complaint raises core matters.

If the matter raised by the complaint is core, the inquiry ends. *Baudoin*. If the matter is no-core, the court still has jurisdiction. If the parties did not consent to entry of a final order by this court on the non-core matter, the court would issue proposed findings of fact and conclusions of law for de novo review in the District Court. But, more significantly, and dispositively, the United States District Court has jurisdiction. 28 U.S.C. §1334(b). The matter is before this court by order of reference which can be withdrawn by a stroke of the District Court pen. 28 U.S.C. §157(a); Bankruptcy Rule 5011(a). Res judicata bars all claims that were or could have been advanced in support of the cause of action on the occasion of its former adjudication, not merely those that were adjudicated. *Matter of Howe*, 913 F.2d 1138, 1144 (5th Cir. 1990). The court recognizes the cases that hold that certain issues must be raised by an adversary proceeding and cannot be included in a contested matter. That is not the issue. This is not a case, for example, where res judication would not apply to bar an action to avoid a lien after a motion to lift stay. Rather, this is litigation resulting from a single

transaction with different forms of relief being requested. The claims raised in this complaint and the claims raised in the Rule 9024 motion could have been raised at one time in the United States District Court, with a referral to this court. The District Court is a court of competent jurisdiction. This court would have been a court of competent jurisdiction. The only procedural issue would have been whether this court or the District Court would have finally decided the non-core matters, if any.

The Fifth Circuit recognizes the important interest in the finality of judgments in bankruptcy cases. *Baudoin*, 981 F.2d at 739. This court's determination of the Coopers' issues has the effect of a judgment rendered by the District Court. Any attempt by the parties to relitigate any of the matters that were raised or could have been raised should be barred by the doctrine of res judicata. This case demonstrates the imperative need for unceasing vigilance in the application of res judicata that the Fifth Circuit addressed in *Baudoin*.

Based on the foregoing,

IT IS ORDERED that the motion to stay consideration of the motion for judgment on the pleadings is DENIED.

IT IS FURTHER ORDERED that the motion for judgment on the pleadings is GRANTED.

IT IS FURTHER ORDERED that this adversary proceeding is DISMISSED.

IT IS FURTHER ORDERED that the third party complaint against Charles B. Brewer and Thompson & Knight, L.L.P., is DISMISSED.

IT IS FURTHER ORDERED that the motion to abstain or, in the alternative, to remand is DENIED as moot.

Signed this 11th day of August, 1995.

/s/
Steven A. Felsenthal
United States Bankruptcy Judge

IN THE
UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	§	
	§	
SOUTHMARK	§	CASE NO.
CORPORATION,	§	389-36324-SAF-11
	§	
DEBTOR.	§	

MEMORANDUM OPINION AND ORDER

[ENTERED March 1, 1995]

Southmark Corporation moves the court under Bankruptcy Rule 9024 for relief from the final order awarding compensation to Coopers & Lybrand. The Southmark examiner employed Coopers to do accounting investigatory work. Coopers had performed accounting and auditing work for Drexel Burnham Lambert. Southmark contends that Coopers failed to disclose to the court, in violation of the Bankruptcy Code and court order, that, during its engagement by the examiner, it discontinued an investigation of certain issues pertaining to Drexel's transactions with Southmark. Southmark asserts that this non-disclosure requires relief from the compensation award and a disgorgement of compensation because Coopers held an interest materially adverse to the bankruptcy estate. The court conducted an evidentiary hearing on December 20, 1994, at which, by stipulation, the parties submitted the issue on a written record.

The determination of compensation under 11 U.S.C. §330(a) for professional persons employed under 11 U.S.C. §§ 105(a) and 327(a) constitutes a core matter over which this court has jurisdiction to enter a final order. 28 U.S.C. §§157(b)(2)(A) and (O) and 1334. By Bankruptcy Rule 9024, this court may grant relief from such a final order. This memorandum opinion contains the court's findings of fact and conclusions of law required by Bankruptcy Rules 7052 and 9014.

Bankruptcy Rule 9024 applies Fed. R. Civ. P. 60(b). By order entered June 6, 1994, the court dismissed claims for relief under Rule 60(b)(2) and (3) but held that Southmark's motion alleged a claim for relief from the final order under Rule 60(b)(6). The court must determine whether Southmark has established a basis to order a disgorgement of compensation under Rule 60(b)(6).

The court adopts as findings of fact the parties' statement of stipulated facts in the pretrial order.

Southmark filed its petition for relief under Chapter 11 of the Bankruptcy Code on July 14, 1989. By order entered September 8, 1989, the court directed that the United States Trustee appoint an examiner to investigate and review allegations of fraud, dishonesty, incompetence, mismanagement or irregularity in the pre-petition management of Southmark and to recommend causes of action discovered in the course of the investigation and review. On the same day the court approved the appointment of Neal Batson as the examiner.

By order entered October 30, 1989, the court conditionally approved the employment by the examiner of Coopers as his accountants. By order dated February 1, 1990, the court confirmed the

approval of the examiner's retention of Coopers, effective as of September 26, 1989. *In re Southmark Corp.*, 113 B.R. 280, 284 (Bankr. N.D. Tex. 1990).

Drexel Burnham Lambert provided investment banking and financial consulting services to Southmark pre-petition. Indeed, Drexel had been Southmark's investment banker on the one billion dollar high risk bonds that were unpaid on the date of the bankruptcy petition. Southmark had extensive dealings with Drexel. In support of its eligibility for employment, Coopers disclosed, by sworn affidavit, that "it provides accounting and consulting services for Drexel in matters unrelated to this case." Coopers did not disclose to the court that it also provided audit services for Drexel. Coopers did not disclose to the court that Drexel paid Coopers approximately $6.7 million for 1987 services, $6.9 million for 1988 services and $4.9 million for 1989 services. The examiner stated in the employment application that, "[t]o the best of Examiner's knowledge, said accounting firm is eligible and qualified to represent the Examiner."

Prior to the examiner's appointment Drexel had pled guilty to federal criminal charges and had agreed to a comprehensive consent decree with the Securities and Exchange Commission settling a civil complaint filed by the SEC. Under the consent decree, a $650 million fund was established to satisfy civil securities claims against Drexel, as well as for other matters. On February 13, 1990, Drexel's parent, the Drexel Burnham Lambert Group, Inc., filed a petition for relief under Chapter 11 of the Bankruptcy Code. The Drexel bankruptcy court set a November 15, 1990, bar date for filing proofs of claims against the Drexel Group.

The examiner's charge covered Southmark's pre-petition transactions with Drexel.

The court conducted two hearings concerning employment of professional persons by the examiner. Coopers' disclosure notwithstanding, Southmark did not object to the employment.

The court determined that the examiner could employ professional persons under §105(a) in this case. *Southmark*, 113 B.R. at 284. Employment eligibility and compensation standards were based, however, on §§327(a) and 330(a). *Id.* Under §327(a), Coopers could not hold or represent an interest adverse to the bankruptcy estate and had to be disinterested as defined by §101(14). Bankruptcy Rule 2014 requires that a professional person seeking employment in a bankruptcy case submit a "verified statement . . . setting forth the person's connections" to the debtor, creditors and other parties in interest. Section 328(c) provides that the court may deny compensation for a professional person employed under §327 if, at any time during that employment, the person is not disinterested or holds or represents an interest adverse to the interest of the estate with respect to the matter on which the person is employed.

By order dated December 15, 1989, this court directed:

> If any party in interest contends that any professional . . . has a conflict of interest that would affect the professional's right to receive compensation, provided the alleged conflict has been disclosed, the party in interest shall raise its contention at the first hearing on

interim compensation following the disclosure or shall thereafter be estopped from doing so.

Southmark did not contend at the first interim compensation hearing that Coopers' disclosed work for Drexel constituted a disqualifying conflict.

The court further ordered that all professional persons had a "continuing obligation to disclose any matter that may affect qualification for court-approved employment under the Bankruptcy Code or disqualification under any relevant ethical consideration."

Coopers engagement team included partners David Carpenter and Knute Kurtz and managers William Galbally, Selene Yu, David Kennedy and Steve Schockett. Carpenter assigned Galbally to investigate possible claims against Drexel. Galbally began his investigation of Drexel in late October 1989. From October 1989 to early December 1989, Galbally billed under 16 hours for Drexel-related work. Galbally's investigation consisted of reviewing materials available in the public domain such as news articles regarding Drexel's activities with Southmark. Galbally also reviewed Drexel brokerage firm materials and Southmark's 1989 Annual Report.

In December 1989, based upon his initial investigation, Galbally concluded that Southmark possibly had significant securities' claims against Drexel that warranted further investigation. Galbally updated Kurtz on the status of his Drexel investigation and expressed his desire to investigate further. On the evening of December 4, 1989, Carpenter and Kurtz met with Galbally at Galbally's apartment to discuss a presentation that Galbally delivered to the examiner earlier that day on non-

Drexel related matters. Galbally again voiced his enthusiasm to the partners about the Drexel investigation and presented Carpenter with a Wall Street Journal article about Drexel.

Carpenter, however, decided to reassign Galbally. Galbally could either be transferred to Philadelphia to work on other engagements or to Atlanta to work on Southmark preference issues with Kennedy. Galbally chose the latter and was transferred to Atlanta. Carpenter then reassigned responsibility for gathering the underlying facts supporting Southmark's potential securities claims against Drexel to Jeffrey Kessler. Kessler did not have investigatory experience. After the reassignment, Coopers billed the examiner over two hundred hours for work involving Southmark transactions with Drexel. Coopers analyzed transfers from Southmark to Drexel for avoidability under Chapter 5 of the Bankruptcy Code. Coopers also investigated and reported to the examiner how Southmark invested the proceeds of the high risk bonds capitalized in the market through Drexel's investment banking services. Coopers did not pursue the securities claims.

Coopers did not file a supplemental disclosure with the court informing the court that it would not investigate potential Southmark securities claims against Drexel.

On April 17, 1990, the examiner informed Southmark regarding Drexel claims. The examiner recognized that Southmark may have securities claims against Drexel but informed Southmark that he would not devote additional resources to further investigate those claims. He reminded Southmark about the Drexel civil disgorgement fund and encouraged Southmark's counsel to pursue the

Drexel issues. The examiner deployed his resources based on the time restraints created by the court's setting of the Southmark confirmation hearings and the Drexel bankruptcy. Because of the exigencies regarding the confirmation process, Southmark did not then pursue the Drexel claims.

The court conducted a hearing on Coopers' application for final allowance of compensation and reimbursement of expenses on November 14, 1990. The court entered its final order on that matter on March 5, 1991, awarding Coopers' approximately $3.7 million. Southmark filed this motion for relief from that order on January 4, 1994.

Coopers disclosed to the court that it provided accounting and consulting services for Drexel on matters "unrelated to this case." Coopers did not disclose to the court that the work included audit services. Coopers did not disclose to the court that Drexel paid Coopers $18.5 million for those services during the 2 1/2 years before the Southmark bankruptcy petition. During the course of Coopers employment, Coopers did not disclose to the court that it recognized but did not pursue an investigation of Southmark securities claims against Drexel.

Based on this court's order entered June 6, 1994, the court must determine whether these non-disclosures support relief under Rule 60(b)(6). Southmark contends that had the disclosures been made, the court would have found an adverse interest or would have found that Coopers was not disinterested for purposes of continued employment under §327 and for payment under §§328(c) and 330(a). Southmark argues that the effect amounts to a fraud on the court. The continuing disclosure obligation imposed by the court pursuant to the Bankruptcy Code implicates a public policy interest

justifying relief from the judgment under Rule 60(b)(6).

The court must determine employment standards and compensation under the Code. To enable the court to fulfill that function, the professional person must make a full disclosure under Rule 2014 of all its connections with the debtor, creditors or parties in interest. It must make a full disclosure of any entity that might have an interest adverse to the estate. By court order, the professional person employed in this case had a continuing obligation to disclose these connections as they become known or developed. Southmark specifically argues that the activities violate the public interest in the fair and equitable treatment of creditors and violate Coopers' duties to the court, thereby threatening the integrity of the judicial process that is designed to assure that the examiner employ only disinterested professional persons who hold or represent no interest adverse to the bankruptcy estate. *See Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994); *In re Leslie Fay Companies, Inc.*, 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1994). Southmark contends that Coopers non-disclosures amount to a fraud on the court, supporting relief from the final compensation order under Rule 60(b)(6).

A professional person who is not disinterested or who holds or represents an interest adverse to the estate may not be employed under §327(a). A professional person not eligible for employment under §327(a) may not be compensated under §330(a) and may be subject to the denial of compensation under §328(c). *In re Federated Department Stores, Inc.*, ___ F.3d ___ (6th Cir. 1995), 1995 WL 13851. Compensation should not be allowed for services rendered by a professional

person who holds conflicting interests even if no fraud or unfairness resulted from the conflict. *Woods v. City National Bank & Trust Co. of Chicago*, 312 U.S. 262, 266 (1941) (under the Bankruptcy Act). The bankruptcy court cannot speculate on what might have been in the absence of a conflict. Where an actual conflict arises, compensation should be denied. *Id.*

Because the court must apply this statutory and case law in the context of a Rule 60(b)(6) motion, the court must focus on the non-disclosures to the court. Pre-petition, Drexel had pled guilty to a criminal charge and had entered a consent decree with the SEC establishing a $650 fund for securities claims. Drexel had been Southmark's investment banker and advisor. Southmark owed $1 billion of high risk bond claims. Within 90 days of its bankruptcy petition, Southmark wrote down the value of its assets by $1 billion eliminating any equity for its publicly traded stock. *See, Southmark*, 113 B.R. at 283. Coopers was engaged by the examiner to investigate Southmark's transactions with, among others, Drexel. Coopers disclosed that it had performed accounting work for Drexel.

Coopers did not inform the court that the accounting work included auditing work and resulted in $18.5 million in fees in the 2 1/2 years before the Southmark bankruptcy case. Coopers investigated transfers by Southmark to Drexel for avoidance analysis and investigated Southmark's investment of high yield bond funds. But when it came time to investigate Southmark's securities claims against Drexel, Coopers pulled its staff, did not pursue the investigation and did not disclose this activity to the court.

Wall Street Journal newspaper articles were already articulating a basis for securities claims. Coopers knew about those articles. Galbally expressed a desire to pursue those claims. Carpenter moved Galbally from the assignment. The parties dispute the actual exchange between Carpenter and Galbally when Carpenter removed him from the assignment. The testimony conflicts. But the actual exchange is not relevant. All that matters is what Coopers actually did or did not do and what Coopers did or did not disclose to the court. Coopers did not pursue the Southmark securities claims against Coopers' client, Drexel. Coopers reassigned its investigatory personnel. Coopers did not inform the court of the magnitude of its work for Drexel. It is one thing to analyze avoidance actions under the Bankruptcy Code or what Southmark did with the high yield bond revenue, it is another thing to investigate securities issues against a client that has paid the accountant $18.5 million in 2 1/2 years, has pled guilty to criminal charges, has entered a consent decree with the SEC establishing a $650 fund and whose parent has filed a Chapter 11 petition.

The court finds that Coopers' failure to fully disclose connections and activities with and regarding Drexel prevented the court from fully performing its function under the Bankruptcy Code and thereby frustrated the purposes of the Code to assure that the professional person employed by the examiner tenders undivided loyalty and provides untainted advice and assistance. *Rome*, 19 F.3d at 58. The court, not the applicant or the professional person, must make the assessment of the §327(a) criteria. The professional person must disclose and continue to disclose all connections that may effect employment eligibility. *Rome*, 19 F.3d at 58-60.

Failure to do so constitutes a basis for relief from the compensation order under Rule 60(b)(6).

The court entered an order requiring continuing disclosure and a procedure for timely and fairly adjudicating the effects of the disclosures. Coopers should have disclosed that its accounting work for Drexel included audit work and the amount of the fees paid by Drexel. When the securities claims theories emerged and Drexel reassigned its personnel, in effect, terminating an investigation of those claims, Coopers should have disclosed to the court that it would not be pursuing those claims. Under the court's procedure, the issue of disinterestedness and material adverse interest would have been addressed at the next interim compensation hearing. The issue would have been resolved, protecting Southmark and its estate, and, for that matter, Coopers and the examiner. The integrity of the Drexel analysis would have been preserved by the resulting court determinations.

A total disgorgement of compensation would be required. *Federated Department Stores*, __ F.3d __, 1995 WL 13851. Bankruptcy courts, however, usually assess compensation disgorgement issues under the particular facts of each case. *Matters of Prudhomme*, 43 F.3d 1000, ___ (5th Cir. 1995); *see, also, Leslie Fay*, 175 B.R. at 533 (discussing conflict analysis). While courts should tend to deny compensation when a professional person holds an interest adverse to the bankruptcy estate or is not disinterested, the court must nevertheless exercise discretion under the facts of a case to assure appropriate relief in complex circumstances. *Gray v. English*, 30 F.3d 1319 (10th Cir. 1994). The court ultimately then must engage in a fact specific inquiry in which the court may balance benefit and/or harm to the estate,

time and labor employed, egregiousness of the professional person's non-disclosure, and so forth. *See In re Kendavis Industries Intern., Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988).

Southmark concedes that Coopers performed valuable services for the examiner on matters not involving Drexel. Indeed Southmark employed Coopers post-confirmation to assist with its proof on the numerous avoidance actions filed in this court. Southmark has recovered substantial sums form its avoidance actions.

Coopers did not cause Southmark to fail to file timely proof of claim in the Drexel bankruptcy case. The examiner alerted Southmark to the Drexel proof of claim bar date and that the examiner would not be developing the securities claims. The basis for the claim was already being suggested in the media. Southmark made conscientious decisions on the deployment of its resources.

Yet, Southmark might have pursued a significant claim against Drexel. Indeed Southmark will likely recover a substantial sum in the range of $20 million from Michael Milken, the director of Drexel's high yield department.

Coopers held a material adverse interest to the bankruptcy estate concerning Drexel. Drexel had paid Coopers $18.5 million in the 2 1/2 years before the bankruptcy petition. Yet Coopers only disclosed that is provided consulting and accounting services to Drexel not related to Southmark. Coopers did not investigate the securities claims against Drexel. Coopers did not disclose to the court that it would not. Drexel had a significant involvement in Southmark's financial transactions, effecting unpaid claims against the Southmark estate and virtually

worthless equity securities. Coopers employment should not have extended to any work regarding Drexel because it held a materially adverse interest to the bankruptcy estate. The examiner's decision not to pursue the Drexel investigation based on time constraints has no bearing on Coopers failure to disclose to the court.

The court concludes that Coopers should disgorge compensation paid in connection with work regarding Drexel. Coopers introduced evidence that Drexel-related fees for the examiner amounted to $55,000. The court accordingly orders a disgorgement of $55,000.

Coopers assignment in the case would have been altered had it made full disclosures. Had it told the court that it had effectively terminated the securities claims investigation on December 4, 1989, the development of those claims would have proceeded on a different basis. Had this issue been confronted in December 1989, the examiner and Southmark would have faced different circumstances concerning Drexel when the examiner confronted his time constraints in April 1990, and when Southmark made its decisions regarding deployment of its available resources to address the exigencies it faced. While the non-disclosure did not cause Southmark to fail to timely file a proof of claim in the Drexel case, the non-disclosure impeded the court's function to assure the integrity of an investigation by professional persons with undivided loyalty. The court should not be left to speculate on how the securities claim against Drexel would have been investigated. Considering the recovery from the Milken litigation, the court must treble the disgorgement amount for an additional sanction of $165,000.00.

Coopers must also reimburse Southmark for the costs and attorneys fees incurred in prosecuting this motion.

Conclusion

Southmark shall recover $220,000.00 from Coopers plus Southmark's attorneys fees and expenses in prosecuting this motion. This amount shall bear post-judgment interest from the date of entry of an order pursuant to Title 28, United States Code. Counsel for Southmark shall file an affidavit detailing the costs and fees incurred by Southmark in prosecuting this motion. Counsel for Southmark shall also prepare an order granting relief from the final order entered March 5, 1991, pursuant to this ruling and an order granting recovery in the specified amounts.

Signed this 27 day of February, 1995.

/s/
Steven A. Felsenthal
United States Bankruptcy Judge

No. 95-340B-G

SOUTHMARK CORPORATION,	§	IN THE DISTRICT COURT
Plaintiff,	§	
VS.	§	OF DALLAS COUNTY, TEXAS
COOPERS & LYBRAND, L.L.P.,	§	134th JUDICIAL DISTRICT
Defendant.	§	

ORIGINAL PETITION

[FILED April 7, 1995]

SOUTHMARK CORPORATION ("Southmark") complains of COOPERS & LYBRAND, L.L.P. ("Coopers") as follows:

I. PARTIES

1. Plaintiff Southmark is a Georgia corporation with its headquarters in Dallas County, Texas. Except as otherwise specified, the term "Southmark" as used herein includes all wholly or partially owned Southmark subsidiaries.

2. Defendant Coopers is a limited liability partnership and a firm of certified public accountants which practices accounting throughout the United States, including the State of Texas. One or more of its partners and managing partners are residents and citizens of the State of Texas, including, but not limited to, Jerry Walker, Managing partner of the Dallas, Texas office.

Defendant Coopers is thus a citizen of the State of Texas for purposes of this suit. Defendant Coopers may be served with process by serving its managing partner, Mr. Jerry Walker, at his regular place of business, 1999 Bryan Street, Suite 3000, Dallas County, Texas 75201-3185.

II. JURISDICTION AND VENUE

3. Southmark sues Coopers for breach of contract, fraud, negligent misrepresentation, breach of fiduciary duty, actual (direct and consequential) damages, exemplary damages, attorneys' fees and interest. Southmark's claims arise out of Coopers' acts, omissions and deceit in purportedly performing professional services on behalf of, and for the benefit of, Southmark. Jurisdiction is proper because the amount in controversy substantially exceeds the Court's minimum jurisdictional limits, and because Coopers is personally present in the State of Texas.

4. Venue is proper in Dallas County, Texas, under Tex. Civ. Prac. & Rem. Code §§ 15.001 because the alleged causes of action occurred in part in Dallas County, Texas.

III. FACTUAL BACKGROUND

5. Southmark was organized in 1970 as a Maryland real estate investment trust, later known as Southmark Properties. In 1981, Gene E. Phillips and William S. Friedman acquired control of Southmark Properties and appointed themselves chairman and vice-chairman, respectively. Southmark Properties' headquarters were moved to Dallas, Texas, and on May 1, 1982, Southmark Properties was converted to a Georgia corporation and its name was changed to Southmark Corporation.

6. The principal business of Southmark was sponsoring private and publicly syndicated real estate partnerships. Through private and public borrowings, Southmark acquired other real estate companies, as well as a savings and loan associations and insurance companies.

7. In April, 1989, following two years of increasing financial distress, Southmark announced a $1 billion write-down of its asset values. This write-down wiped out Southmark's shareholders' equity, reducing equity from $605 million to negative $428 million. On July 14, 1989, Southmark filed a Chapter 11 bankruptcy proceeding in Atlanta. The case was subsequently transferred to Dallas. Under the plan of reorganization adopted by the Bankruptcy Court, holders of Southmark's more than one billion dollars in public debt received approximately five cents on each dollar of their investment in cash, as well as securities in the reorganized Southmark which could be worth as much as another 15 cents on the dollar.

8. From 1982 until shortly before Southmark's bankruptcy in 1989, Drexel Burnham Lambert, Inc. ("Drexel") served as underwriter, broker and financial advisor to Southmark and several of its subsidiaries. Virtually all of Southmark's dealings with Drexel were directly with the High Yield Department, run by Michael Milken. Through the High Yield Department, Drexel was able to foster and sustain the illusion of a liquid market for issues of high yield corporate debt and preferred stock, which eventually and more accurately came to be known as "junk bonds." Underwriting junk bond issues and manipulating the junk bond markets

earned Drexel exorbitant profits through underwriting fees, markups and trading profits.

9. Issuers of Drexel-underwritten bonds were forced through a variety of means to invest a portion of the issue proceeds in junk bonds underwritten by Drexel for other clients. Drexel clients who refused to invest in junk bonds found Drexel unwilling to underwrite further debt or preferred stock issues, which were frequently necessary just to retire maturing debt or redeem earlier preferred stock issues. Drexel clients who did not continue to purchase Drexel-underwritten bonds for their own portfolios also found Drexel unwilling to sell bonds the companies already owned.

10. Through the efforts of Drexel, Southmark raised well over a billion dollars through high-interest public debt issues, which quickly imposed huge interest expense and principal repayment obligations on Southmark. The debt incurred by Southmark was well in excess of the legitimate operational needs of the company. Southmark was induced by Drexel to invest the excess funds, over $400 million, in high-yield bonds of other Drexel clients. Southmark ultimately lost in excess of $150 million on these junk bonds in 1988 and 1989. The crushing burden of debt service on junk bond issues, combined with devastating losses in its junk bond portfolio, contributed directly and substantially to Southmark's demise.

11. On July 28, 1989, shortly after it filed for bankruptcy, Southmark moved the Bankruptcy Court for the appointment of an Examiner, stating, "the Debtor believes that it is in the best interests of the estate and this Chapter 11 case to have a disinterested, independent individual review and investigate the pre-Chapter 11 activities of the

debtor as they relate to third party transactions and relationships, and potential causes of action against such third parties on behalf of Southmark and the estate." Southmark sought "an unbiased, independent assessment as to whether legal action by Southmark against various third parties, including any of its former officers and directors, is appropriate and should be pursued."

12. On September 8, 1989, the Bankruptcy Court issued an order approving the appointment of Neal Batson, a partner in the firm of Alston & Bird, as Examiner. The order charged the Examiner with the "investigation and review of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor, and . . . making recommendations as to causes of action discovered in such investigation and review." The Court specifically authorized the Examiner to retain "attorneys and accountants to assist the Examiner in investigation and review, the fees and expenses of such professionals to be paid from the estate upon proper application." On September 14, 1989, the Court approved the appointment of Alston & Bird as attorneys to assist the Examiner.

13. On September 26, 1989, the Examiner applied to the Court for an order authorizing the employment of Coopers as accountants to the Examiner, to investigate allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor. In addition, Coopers was to explore possible causes of action that Southmark might have against various third parties arising out of such activities. Coopers received fees in excess of $4 million directly from Southmark for this engagement.

Among the potential claims that Southmark had were claims against Drexel arising out of Drexel's roles as underwriter of bonds sold by Southmark and as broker for bonds purchased by Southmark. Drexel, however, was also a large and lucrative audit client of Coopers.

14. Attached to the application of the Examiner was an affidavit from David A. Carpenter, the engagement partner from Coopers. In paragraph 3 of that affidavit, Carpenter listed all "known connections" between Coopers and other parties in interest. Mr. Carpenter noted that "Coopers & Lybrand provides accounting and consulting services for Drexel in matters unrelated to this case." Mr. Carpenter did not indicate that Coopers' relations with Drexel would in any way impede or interfere with its duties as accountants to the Examiner.

15. The appointment of Coopers was subsequently approved by the Court, effective September 26, 1989. Most of the investigative work between September 26, 1989 and July 9, 1990, the date of the Examiner's final report, was performed by Coopers. Indeed, Coopers itself wrote substantial portions of the various reports filed by the Examiner.

16. On or about October 1, 1989, there was an initial meeting of the Coopers engagement team, which consisted of David Carpenter, Knute Kurtz (a new partner working under Carpenter), and a number of managers, including William Galbally. At that meeting, Carpenter assigned various members of the team to work on and investigate specific issues concerning the Southmark bankruptcy. Mr. Galbally was assigned to investigate issues including but not limited to

possible claims that Southmark might have against Drexel arising, *inter alia*, out of Drexel's relationship as underwriter of bonds sold by Southmark and as broker of "high yield" bonds.

17. Between October 2, 1989 and approximately December 4, 1989, Mr. Galbally worked on the Drexel issue along with other litigation-related issues in the engagement. He viewed the Drexel issue as being very important and believed that Southmark had substantial claims against Drexel in connection with Drexel's activities, including those as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark. Mr. Galbally told Mr. Kurtz, among others, about the potential significance of the claims against Drexel.

18. On or about the night of December 4, 1989, Mr. Carpenter and Mr. Kurtz visited Mr. Galbally at his apartment in Dallas to discuss Southmark's potential claims against Drexel. After Mr. Galbally explained that he believed claims against Drexel might be Southmark's most significant claims, he was told to leave Drexel alone because Drexel was a significant audit client of Coopers. Mr. Galbally persisted that the Drexel issues had to be investigated and presented a Wall Street Journal article dealing with Drexel's role in Southmark's demise. Mr. Carpenter then told Mr. Galbally that he was being taken off the issues related to Drexel. Mr. Galbally was subsequently sent to Atlanta to work on preference actions under David Kennedy, which was essentially a demotion since Mr. Kennedy was Mr. Galbally's junior at Coopers.

19. On or about January 3, 1990, the potential claims against Drexel were reassigned to another Coopers' employee. Although further time was

billed to the Drexel investigation, no good faith attempt was made to develop the claims identified by Mr. Galbally.

20. On February 13, 1990, Drexel's parent, Drexel Burnham Lambert Group, filed for bankruptcy under Chapter 11. November 15, 1990 was set as the bar date for the assertion of pre-petition claims against Drexel.

21. On March 1, 1990, John C. Weitnauer of Alston & Bird, counsel for the Examiner, wrote to R. Paul Wickes of the Thompson & Knight firm to explain that Southmark might wish to pursue certain claims against Drexel in connection with the Examiner's review of potential preferential transfers, of which Drexel may have received $985,000 or more. Mr. Weitnauer's letter did not, however, mention any potential claims that Southmark might have against Drexel arising out of Drexel's activities investigated by Mr. Galbally, including those as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

22. On April 17, 1990, Neal Batson, the Southmark Examiner, sent a letter to Mr. Wickes of Thompson & Knight (with copies to David Carpenter and Knute Kurtz) advising Thompson & Knight to pursue a "potential voidable preference paid to Drexel Burnham Lambert Incorporated . . . within the ninety-day period prior to Southmark's Chapter 11 filing on July 14, 1989." In this letter, the Examiner specifically states that he and his experts "have not attempted to investigate" any "securities claims which Southmark may have as the purchaser of bonds underwritten or sold by Drexel." The Examiner also stated that "[i]n light of the plan requirement that the Examiner file his final report

by conclusion of the hearings on confirmation and the recent bankruptcy of the parent, we are not inclined to devote additional resources to a further investigation of any potential Southmark claims against Drexel." At the time the April 17, 1990 letter was written and at all pertinent times thereafter, the Examiner was unaware of the work performed and theories developed by Mr. Galbally, unaware of the circumstances surrounding his removal from the Drexel examination, and unaware of Coopers' decision not to develop and assert claims against Drexel.

23. At no time during the course of Coopers' engagement on the Southmark bankruptcy did Coopers inform the Examiner, counsel for Southmark, or Southmark itself that Coopers was holding back from a full investigation of potential claims that Southmark might have against Drexel.

24. At no time during the course of Coopers & Lybrand's engagement on the Southmark bankruptcy did Coopers inform the examiner, counsel for Southmark, or Southmark itself that the Coopers employee originally charged with investigating the Drexel claims believed, contrary to the Reports prepared for the Examiner, that Southmark had substantial claims against Drexel arising out of Drexel's activities as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

25. The bar date for filing pre-petition claims in the Drexel bankruptcy was November 15, 1990. Southmark's plan of reorganization (the "Plan") was confirmed on July 23, 1990 and Southmark emerged from chapter 11 in August 1990. At that point, Southmark had limited cash due in no small part to its payment of professional fees during the

bankruptcy, including more than $4 million paid to Coopers to investigate claims against, among others, Drexel. Southmark nevertheless was faced with having to make an immediate decision on whether to commission outside counsel to investigate claims against Drexel in advance of the November 15, 1990 bar date. Southmark knew nothing of Mr. Galbally's theories, and enthusiasm for pursuit of claims against Drexel. Southmark knew nothing of Coopers' predisposition to not seriously further investigate such claims. Southmark did know that Coopers had reported that proving claims against Drexel was "made difficult by the facts." Southmark believed that the downplaying of the Drexel claims at the same time Coopers was devoting substantial resources to far smaller claims was a reflection of Coopers belief that claims against Drexel relating to the issuance of junk bonds were not likely to be meritorious or to lead to a substantial recovery. As a result, Southmark did not further examine potential claims against Drexel, and did not file a proof of claim in the Drexel bankruptcy.

26. In early 1991, after the bar date for filing claims against Drexel has passed, Southmark investigated claims that could be asserted against Michael Milken, individually. That investigation revealed the existence of claims substantially similar to the claims Mr. Galbally had wanted to pursue but had been kept secret by Coopers.

27. As a result of the 1991 investigation, Southmark filed suit against Michael Milken and others in July 1991. As part of his settlement with the U.S. government, Mr. Milken has established a fund to cover claims asserted against him arising out of his junk bond activities. Southmark has reached

an agreement to resolve the Milken litigation pursuant to which Southmark is expected to recover in excess of $25 million out of the Milken settlement fund. A similar fund was created to fund claims asserted against Drexel in its bankruptcy proceeding. Southmark could have realized a substantially similar recovery from the Drexel fund had it known of the viability of its claims and timely filed a claim in the Drexel bankruptcy. Southmark did not know of the discovery of its claims because Coopers kept such information secret.

28. Southmark learned of Cooper's duplicity on April 8, 1993, when its General Counsel was told by William Galbally of the results of his investigation and his removal from the assignment because of Cooper's audit relationship with Drexel. Southmark thereafter filed a motion in the bankruptcy court seeking reconsideration of the fees Coopers received from its Southmark engagement. On February 27, 1995, the bankruptcy court issued its Memorandum Opinion and Order in which it was determined that Coopers was required to disgorge a substantial portion of the compensation paid to it from the engagement, plus Southmark's fees and expenses in prosecuting the motion for reconsideration in the bankruptcy court.

29. All conditions precedent to Southmark's rights to recover on each of its separate causes of action have been performed or have occurred.

IV. CAUSES OF ACTION

A. Count One - Breach of Contract

30. The applicable statutes of limitation do not bar any of Southmark's claims insofar as Coopers actively and continually concealed the facts giving rise to Southmark's claims through misrepresentations,

omissions and deceit; Southmark did not discover nor, in the exercise of reasonable diligence, could it have discovered the facts giving rise to Southmark's claims before the applicable limitation periods commenced dating back from the filing of this action; and the applicable limitation periods were tolled and have not ended. Accordingly, Southmark's claims are timely filed.

31. Although a by-product of the bankruptcy process, Coopers agreed to investigate third party claims held by Southmark, including claims held by Southmark against Drexel, and Southmark agreed to pay for such investigation. Southmark paid Coopers over $4 million pursuant to this agreement, fully performing its obligations.

32. Coopers breached its contract with Southmark by failing to fully investigate claims against Drexel, and, indeed, by stonewalling efforts by one of Defendant's employees to investigate claims against Drexel.

33. The breach of contract alleged herein proximately caused damage to Southmark.

34. On the basis of this cause of action, Southmark is entitled to recover actual damages, attorneys' fees, pre-judgment interest, post-judgment interest, and cots of court.

B. Count Two - Fraud and Deceit

35. Coopers engaged in common law fraud by (a) employing devices, schemes, conspiracies and artifices to defraud, (b) making untrue statements of material facts or omitting to state material facts necessary to make the statements made in light of the circumstances under which they were made, not misleading, and (c) engaging in acts, practices and a

course of business which operated as a fraud or deceit upon Southmark. Coopers made false representations of material fact to Southmark, which it either knew to be false or as to which it was reckless as to the truth of the representations. In addition, Coopers failed to disclose material facts to Southmark regarding its relationship with Drexel and its subversion of the Examiner's investigation of claims against Drexel. Coopers intended for Southmark to rely on its representations, and knew its misrepresentations and omissions of material fact would be misleading to Southmark. Southmark relied on these representations.

36. Among other things, Coopers represented to Southmark that the reason Coopers did not develop claims against Drexel was because of lack of time, lack of corroborative evidence, and the fact that Drexel had filed for bankruptcy. In fact, however, Coopers never intended to investigate claims against Drexel, its largest audit client, and it deliberately suppressed evidence concerning such claims developed by one of its managers.

37. Cooper's fraud proximately caused damage to Southmark. It was committed intentionally, willfully, maliciously and with a conscious indifference to the rights of Southmark. Southmark is therefore entitled to an award of exemplary damages, in addition to its actual damages, in an amount to be determined by the jury commensurate with the facts of this case and in accordance with the law.

C. Count Three - Breach of Fiduciary Duty

38. Alternatively, as a result of its appointment to investigate claims on behalf of Southmark, and the relationship of trust and confidence created thereby,

Coopers had a fiduciary relationship with Southmark and owed it fiduciary duties, including duties of care, good faith and loyalty.

39. Coopers violated its fiduciary duties to Southmark, including, but not limited to the duties of care, good faith and loyalty. Coopers also engaged in unconscionable conduct towards Southmark by, among other things, subverting the investigation of claims against Drexel in the interest of Drexel and contrary to the interest of Southmark.

40. The breaches of fiduciary duty by Coopers proximately caused damage to Southmark. The breaches of fiduciary duty were committed intentionally, willfully, maliciously and with a conscious indifference to the rights of Southmark. Therefore, Southmark is entitled to an award of exemplary damages, in addition to its actual damages, in an amount to be determined by the jury commensurate with the facts of this case.

D. Count Four - Negligent Misrepresentation

41. Pleading further in the alternative, Coopers made false representations for the guidance of Southmark in its business. In the course of its business and in a transaction in which it had a pecuniary interest, Coopers did not exercise reasonable care or competence in obtaining the information on which those representations were based and in communicating that information, and Southmark suffered pecuniary loss by justifiably relying on the representations. Coopers' negligent misrepresentations alleged herein proximately caused damage to Southmark and were committed intentionally, willfully, maliciously and with a conscious indifference to the rights of Southmark. Therefore, Southmark is entitled to an award of

exemplary damages, in addition to actual damages, in an amount to be determined by the jury commensurate with the facts of this case.

V. DAMAGES

A. Actual (Direct and Consequential) Damages

42. Coopers' acts and practices described above have caused, and continue to cause, Southmark to suffer substantial actual damages to its business, both direct and consequential. Coopers is therefore liable for its wrongful conduct in an amount far in excess of the minimal jurisdictional limits of this court.

B. Exemplary Damages

43. Because Coopers' conduct constitutes fraud and misrepresentation, and because Coopers has acted with malice or with heedless disregard for Southmark's rights, Coopers is liable for substantial exemplary damages.

C. Attorneys' Fees

44. Southmark is entitled to its reasonable attorneys' fees pursuant to Tex. Civ. Prac. & Rem. Code § 38.001.

D. Interest

45. Southmark is entitled to compound pre-judgment interest at the rate set by Tex. Rev. Civ. Stat. Ann. art. 5069-1.05.

46. Southmark is entitled to post-judgment interest at the maximum rate permitted by law.

WHEREFORE, Plaintiff Southmark prays for judgment against Defendant Coopers, finding it liable to Southmark, and praying specifically that it have:

1. a trial by jury;
2. all of Southmark's actual damages;
3. exemplary damages in an amount which Southmark may show to be appropriate;
4. pre-judgment interest and post-judgment interest at the maximum rate(s) permitted by law or equity;
5. reasonable attorneys' fees and costs; and
6. such other and further relief as to which Southmark may show itself to be justly entitled.

Respectfully submitted,

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THE CONSTITUTION OF THE UNITED STATES OF AMERICA

ARTICLE III

Section 1. The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish. The Judges, both of the supreme and inferior Courts, shall hold their Offices during good Behaviour, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office.

UNITED STATES CODE

28 U.S.C. § 1334(c)(2)

Upon timely motion of a party in a proceeding based upon a State law claim or State law cause of action, related to a case under title 11 but not arising under title 11 or arising in a case under title 11, with respect to which an action could not have been commenced in a court of the United States absent jurisdiction under this section, the district court shall abstain from hearing such proceeding if an action is commenced, and can be timely adjudicated, in a State forum of appropriate jurisdiction.

28 U.S.C. § 157

§ 157. Procedures

(a) Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.

(b) (1) Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title.

(2) Core proceedings include, but are not limited to--

(A) matters concerning the administration of the estate;

(B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for

the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11;

(C) counterclaims by the estate against persons filing claims against the estate;

(D) orders in respect to obtaining credit;

(E) orders to turn over property of the estate;

(F) proceedings to determine, avoid, or recover preferences;

(G) motions to terminate, annul, or modify the automatic stay;

(H) proceedings to determine, avoid, or recover fraudulent conveyances;

(I) determinations as to the dischargeability of particular debts;

(J) objections to discharges;

(K) determinations of the validity, extent, or priority of liens;

(L) confirmations of plans;

(M) orders approving the use or lease of property, including the use of cash collateral;

(N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate; and

(O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity

security holder relationship, except personal injury tort or wrongful death claims.

(3) The bankruptcy judge shall determine, on the judge's own motion or on timely motion of a party, whether a proceeding is a core proceeding under this subsection or is a proceeding that is otherwise related to a case under title 11. A determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law.

(4) Non-core proceedings under section 157(b)(2)(B) of title 28, United States Code, shall not be subject to the mandatory abstention provisions of section 1334(c)(2).

(5) The district court shall order that personal injury tort and wrongful death claims shall be tried in the district court in which the bankruptcy case is pending, or in the district court in the district in which the claim arose, as determined by the district court in which the bankruptcy case is pending.

(c) (1) A bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11. In such proceeding, the bankruptcy judge shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected.

(2) Notwithstanding the provisions of paragraph (1) of this subsection, the district court, with the consent of all the parties to the proceeding, may refer a proceeding related to a case under title 11 to

a bankruptcy judge to hear and determine and to enter appropriate orders and judgments, subject to review under section 158 of this title.

(d) The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.

(e) If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all the parties.

Supreme Court, U.S.
FILED
MAY 12 1999
CLERK

No. 98-1643

In the

Supreme Court of the United States

October Term, 1998

IN THE MATTER OF: SOUTHMARK CORPORATION,

Debtor.

SOUTHMARK CORPORATION,

Petitioner,

v

COOPERS & LYBRAND L.L.P.,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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COUNTER-STATEMENT OF QUESTION PRESENTED

Whether claims alleging official misconduct by bankruptcy court-appointed professionals constitute core bankruptcy proceedings.

DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule of Procedure 29(6), Respondent Coopers & Lybrand L.L.P. has no parent corporations and no wholly-owned subsidiaries. Effective July 1, 1998, Coopers and Lybrand L.L.P. and Price Waterhouse LLP combined their practices to form Pricewaterhouse Coopers LLP.

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ARGUMENT

The fact-based decision of the court below does not conflict with any decision of this Court or of any Court of Appeals. The Fifth Circuit's holding that state-law contract and tort claims asserted by Southmark Corporation ("Southmark") against Coopers & Lybrand L.L.P. ("Coopers") were a core bankruptcy proceeding because they arose out of alleged misconduct in Coopers' performance of its duties as the accounting firm appointed by the bankruptcy court in Southmark's Chapter 11 bankruptcy is in accordance with Congress' grant of jurisdiction to bankruptcy courts, 28 U.S.C. § 157 (b)(1), and with this Court's decision in *Northern Pipeline Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

I. The Decision Of The Fifth Circuit Maintains The Constitutional Limits Prescribed By *Marathon*.

Under *Marathon*, bankruptcy courts exercise jurisdiction over actions that fall within "the core of the federal bankruptcy power," which the Court described as "the restructuring of debtor-creditor relations." 458 U.S. at 71. To determine whether a proceeding resides within that core bankruptcy power, it is settled that a court cannot focus exclusively on whether the claims arise under state law, or can be resolved under state law. *See* 28 U.S.C. §157(b)(3) ("A determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law."); *Arnold Print Works, Inc. v. Apkin (In re Arnold Print Works, Inc.)*, 815 F.2d 165, 169 (1st Cir. 1987) (Breyer, J.); *see also Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 853 (1986) ("[T]here is no reason inherent in separation of powers principles to accord

the state law character of a claim talismanic power in Article III inquiries."). Instead, the court should inquire into the nature of the proceeding—how the proceeding relates to the basic function of the bankruptcy court. *See Arnold*, 815 F.2d at 169. Under this analysis, the Fifth Circuit's fact-bound decision is consistent with the constitutional scope of the bankruptcy power enunciated in *Marathon*.

A. Southmark's Claims Are In The Nature Of A Challenge To Cooper's Disinterestedness As A Bankruptcy Court-Appointed Professional.

Southmark's claims against Coopers for breach of contract, fraud and deceit, breach of fiduciary duty, and negligent misrepresentation arise out of Coopers' alleged misconduct as the bankruptcy court-appointed accountant for the examiner in the Southmark bankruptcy case. Pet. at 57a-72a. For example, in its fraud and deceit count, Southmark alleged that

> Coopers represented to Southmark that the reason Coopers did not develop claims against Drexel was because of lack of time, lack of corroborative evidence, and the fact that Drexel had filed for bankruptcy. In fact, however, Coopers never intended to investigate claims against Drexel, its largest audit client, and it deliberately suppressed evidence concerning such claims developed by one of its managers.

Pet. at 69a ¶36. Similarly, Southmark's breach of fiduciary duty count alleged that Coopers "subvert[ed] the

investigation of claims against Drexel in the interest of Drexel and contrary to the interest of Southmark." Pet. at 70a ¶39.

Southmark does not contest that its claims are based on Coopers' alleged bias in performing its duties as the court-appointed accounting firm, but argues that the "substantive nature" of the claims is that they are "state-created private rights," based in large part on the fact that the claims arise under state law and are to be decided through application of standards supplied by state law. Pet. at 11-12. The argument that a proceeding is non-core because it will be resolved under state law has been explicitly rejected in the Bankruptcy Code. *See* 28 U.S.C. §157(b)(3).

Southmark's claims cannot be divorced from the bankruptcy context within which they arose. Like an examiner or a trustee, a court-appointed professional is a creature of the bankruptcy process. As such, it owes a duty not only to the estate on whose behalf it was retained, but also to the examiner/trustee, the creditors and the court, and no claim against it can be determined without consideration of these varied obligations. The duties of Coopers and any claims against Coopers for its alleged breach of those duties are dependent upon its role in the bankruptcy process and could not exist but for that process.

B. Ensuring The Disinterestedness Of Court-Appointed Professionals Is Essential To The Proper Functioning Of The Bankruptcy Court And Therefore Is Within The Core Bankruptcy Power.

Court-appointed professionals play a prominent role in the bankruptcy process and, as was the case here, are often entrusted with significant responsibility in connection with the administration of the bankruptcy estate. In recognition of the role played by such professionals, the Bankruptcy Code requires that professionals "do not hold or represent an interest adverse to the estate, and that [they] are disinterested persons." 11 U.S.C. §327(a). The disinterestedness requirement, in particular, is strictly enforced in order to maintain the integrity of the bankruptcy process. *See In re Diamond Mortgage Corp.*, 135 B.R. 78, 90 (Bankr. N.D. Ill. 1990); *see also Pierson & Galen v. Creel & Atwood (In the Matter of Consolidated Bancshares, Inc.)*, 785 F.2d 1249, 1256 n.6 (5th Cir. 1986). To that end, bankruptcy courts are charged with an ongoing obligation to "root out impermissible conflicts of interest" whenever they arise. *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994) (quotation omitted); *see In re Vebeliunas*, No. 98 B 45466, 1999 WL 152577, at *3 (Bankr. S.D.N.Y. Mar. 10, 1999) (the disinterestedness requirement "is so crucial to the proper functioning of the bankruptcy system," the court may address any alleged lack of disinterestedness whenever the issue arises) (a copy is attached at Appendix 34b).

The non-core claims in *Marathon* and *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33 (1989), upon which Southmark relies, are of an entirely different nature than the claims raised by Southmark. In *Marathon*, the debtor asserted a contract

claim against Marathon in relation to a pre-petition agreement to construct a pipeline. *Granfinanciera* involved an action in which the bankruptcy trustee alleged that a non-creditor had received a fraudulent conveyance from the debtor prior to bankruptcy. In both cases, the claims related to pre-petition conduct that possessed neither a temporal nor structural nexus to the bankruptcy process. In contrast, Southmark's claims against Coopers arose during and in the conduct of the bankruptcy proceeding; without the bankruptcy proceeding, Coopers would have had no relationship with Southmark and the claims would not exist.

Southmark's own Motion to Reconsider Award of Fees to Coopers & Lybrand and Brief in Support Thereof (a copy is attached at Appendix 1b) demonstrates the core nature of its claims:

> Shielding one of its largest clients from claims that could have substantially enhanced creditor recoveries was plainly inimical to the interests of Southmark's creditors and a violation of Coopers & Lybrand's fiduciary and statutory duties. . . . *[T]his type of misconduct threatens the very integrity of, and the public trust in, the bankruptcy process.*

¶58 (emphasis added). Southmark argued further that Coopers' conduct constituted fraud on the court, which Southmark described as "fraud committed by an officer of the court *which affects the judicial machinery in such a way that the judicial machinery cannot perform in the usual manner* its impartial task of adjudging cases that are presented for adjudication." *Id.* at ¶59 (internal quotation omitted and emphasis added).

Claims concerning conduct that "threatens the very integrity of . . . the bankruptcy process" and that prevents the court from "perform[ing] in the usual manner" involve the core bankruptcy power. That proposition is no less self-evident because the claims are cast in terms of tort or contract rather than a fee objection, or because the claims are asserted in state court rather than bankruptcy court.

C. Failure To Treat Southmark's Claims As Core Bankruptcy Proceedings Would Undermine The Power Of The Bankruptcy Court To Restructure Debtor-Creditor Relations.

Southmark argues that, to the extent its claims of official misconduct against Coopers do implicate "public rights," those rights were vindicated by the bankruptcy court's order disgorging a portion of Coopers' fees. Therefore, in Southmark's view, it is free to pursue its private rights in another forum.

Such a procedure would seriously undermine the power of the bankruptcy court to control the conduct of court-appointed officers. In the analogous context of a bankruptcy court's denial of leave to sue a trustee in state court, the Seventh Circuit, through Chief Judge Posner, stated:

> At stake in the present case, however, is a concern . . . with the integrity of the bankruptcy jurisdiction. If debtors, creditors, defendants in adversary proceedings, and other parties to a bankruptcy proceeding could sue the trustee in state court for damages arising out of the conduct of the proceeding, that court would

> have the practical power to turn bankruptcy losers into bankruptcy winners, and vice versa.

In the Matter of Linton, 136 F.3d 544, 546 (7th Cir. 1998). Similarly, if debtors are permitted to raise what are essentially fee objections in state court following an adverse decision by the bankruptcy court, the state court in essence gains the power to turn a fee loser into a fee winner.

This instant case is a perfect example of this concern. Southmark became aware of Coopers' alleged misconduct in 1993. It subsequently moved in bankruptcy court for disgorgement of Coopers' entire $4 million fee. In March of 1995, the bankruptcy court ordered Coopers to disgorge $220,000 of its fee, plus pay Southmark's legal fees and costs for its motion. The bankruptcy court also held that Coopers' conduct did not cause Southmark to fail to file timely a proof of claim in the Drexel Burnham Lambert, Inc. bankruptcy case. Neither Southmark nor Coopers appealed this decision and the judgment was immediately paid in full. It was not until after that decision that Southmark filed its state-law claim, alleging virtually identical facts as it had before the bankruptcy court and, in part, seeking the same relief. The fact that Southmark waited until 1995 to bring its state-law action shows that the state-law action is a collateral attack on what Southmark believed to be an unsatisfactory bankruptcy court decision on a core proceeding: the conduct of court-appointed professionals.

Southmark argues that permitting bankruptcy courts to adjudicate claims such as the ones it has asserted against Coopers interferes with the sovereignty of the state courts. To a large extent, this contention is subsumed by the question of whether the claims are core—if the action is a core

proceeding, by definition it is federal in nature. Moreover, a regard for state sovereignty does not mean that states should have the power to interfere with the bankruptcy court's indisputable power to control the award of professionals' fees, as would be the case here.

II. The Courts Of Appeals Are In Agreement That Claims Of Misconduct By Court-Appointed Officers In The Performance Of Their Official Duties Constitute Core Bankruptcy Proceedings.

Southmark argues that the Court should resolve the "[c]onfusion over what claims fall within the core of the federal bankruptcy power." Pet. at 22. Although the Courts of Appeals may differ somewhat on the outer constitutional limits of what constitutes "core proceedings," there is no disagreement that actions of the sort initiated by Southmark against Coopers fall squarely within the constitutional confines of the core of the bankruptcy power.[1]

In addition to the decision of the Fifth Circuit below, three Courts of Appeals have found that actions alleging misconduct of court-appointed persons in the performance of

[1] The vast majority of bankruptcy courts faced with this question similarly have found that claims against court-appointed individuals for alleged misconduct in the performance of their official duties are core proceedings. *See, e.g., In re Envirodyne*, 174 B.R. 955, 964 (Bankr. N.D. Ill. 1994) (claims against official committee members); *In re Elegant Equine, Inc.*, 155 B.R. 189, 191 (Bankr. N.D. Ill. 1993) (action against former trustee for breach of fiduciary duty); *In re American Solar King*, 142 B.R. 772, 773 (Bankr. W.D. Tex. 1992) (breach of fiduciary duty by trustee); *In re Balboa Improvements, Inc.*, 99 B.R. 966, 969 (B.A.P. 9th Cir. 1989) (claims against debtor's attorney for interference with prospective economic advantage, fraud, interference with contract, negligence, malpractice and detriment to the estate).

their official duty constitute core proceedings. In *Sanders Confectionery Products, Inc. v. Heller Financial, Inc.*, 973 F.2d 474 (6th Cir. 1992), debtor's parent corporation sued one of debtor's lenders, the lender's attorneys and the bankruptcy trustee for, *inter alia*, common law fraud, securities fraud and RICO violations arising from the making and administering of a loan to debtor. In addressing the district court's conclusion that the action was a core proceeding, the Third Circuit pronounced that, although the action against the lender and its attorneys was non-core, the action against the trustee was a core proceeding. *Id.* at 483 n.4. According to the court, "[w]hile the specific causes of action . . . exist independently of bankruptcy cases, an action against a bankruptcy trustee for the trustee's administration of the bankruptcy estate could not." *Id.* Accordingly, because "[a]ll claims against [the trustee] related to his conducted during the . . . bankruptcy," they were core proceedings. *Id.*

The Ninth Circuit reached a similar conclusion in *Walsh v. Northwestern National Insurance Co. (In re Ferrante)*, 51 F.3d 1473 (9th Cir. 1995). In *Ferrante*, a successor Chapter 11 trustee brought an adversary action in the bankruptcy court against the surety of the previous trustee, alleging embezzlement and breach of fiduciary duty by the prior trustee in connection with his administration of the bankruptcy estate. The court held that the successor trustee's action was a core proceeding because it "concern[ed] the administration of the estate." *Id.* at 1476 (quotations omitted). The court explained: "Because this case evokes the Bankruptcy Act's imposition of duties on trustees to administer estate property . . . , it cannot be gainsaid that it involves a core issue." *Id.*

Finally, the Third Circuit, in *Billing v. Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242, 1249-50 (3d Cir. 1994), held that a separate malpractice action against debtor's attorneys, who were retained by court order, was part and parcel with debtor's objections to the attorneys' fee application, and therefore was within the bankruptcy court's core jurisdiction. In that case, debtor retained the law firm of Ravin, Greenberg & Zackin, P.A. ("RG&Z"). Following approval of the reorganization plan, RG&Z applied to the court for attorneys' fees, which the debtor opposed on grounds of legal malpractice. The debtor also concurrently brought suit against RG&Z for malpractice in the district court.

On appeal, neither party contested the district court's finding that the malpractice suit constituted a core proceeding, and therefore the issue was not addressed directly by the court. However, in finding that RG&Z did not have a right to a jury trial on the malpractice claims,[2] the court held that, by raising legal malpractice as a defense to RG&Z's application for fees, the claims were converted "into an equitable dispute over a share of the estate." *Id.* at 1253. The court explained, "[t]he close connection between the malpractice action and the objections to fees leads us to conclude that the debtors' allegations of malpractice are part of the process of allowance and disallowance of claims." *Id.* at 1252. Therefore, like the decisions in *Sanders Confectionery* and *Ferrante*, this decision is entirely consistent with the decision of the Fifth Circuit below.

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[2] As noted by Southmark, this Court has explained that a determination that a party is not entitled to a jury trial on an issue before a bankruptcy court is tantamount to a finding that the bankruptcy court has jurisdiction over the claim. *See Granfinanciera*, 492 U.S. at 53 (*quoted in* Pet. at 14 n.4).

Southmark ignores *Sanders Confectionery*, *Ferrante* and *Billing* and cites the Ninth Circuit's decision in *Taxel v. Electronic Sports Research (In re Cinematronics, Inc.)*, 916 F.2d 1444 (9th Cir. 1990), and the Third Circuit's decision in *Torkelson v. Maggio (In re Guild and Gallery Plus, Inc.)*, 72 F.3d 1171 (3d Cir. 1996), to try to show a conflict between the Courts of Appeals. This purported conflict is wholly illusory.

In *Cinematronics*, the Ninth Circuit did not address the issue of whether an action alleging misconduct against a court-appointed person in the performance of his official duties constituted a core proceeding. In that case, debtor was sued in state court by a company unrelated to the bankruptcy. The Chapter 11 trustee brought an action in bankruptcy court against the third-party, alleging a violation of the automatic stay provisions of the Bankruptcy Code (the "stay proceeding"). The third-party responded in the stay proceeding by asserting a counterclaim against the trustee, and a third-party complaint against debtor's president, alleging, *inter alia*, breach of contract and breach of fiduciary duty. Upon motion to determine the court's jurisdiction, the bankruptcy court held that the counterclaims and third-party complaint were core proceedings. Debtor's president thereafter moved in the district court to withdraw the reference to the bankruptcy court so that a jury trial could be conducted on the core issues. The district court denied the motion.

On appeal, the Ninth Circuit held that the third-party complaint against debtor's president did not raise core issues. However, because the court found that the trustee lacked standing to bring an appeal, *id.* at 1148, it never addressed whether the counterclaims against the trustee were core. In fact, the issue was not even before the court because the

trustee neither challenged the bankruptcy court's finding that the counterclaims were core proceedings, nor moved in the district court to withdraw the reference based on his right to a jury trial. *See id.*

Presumably, Southmark is arguing that the court's holding with respect to debtor's president, in essence, is a holding that the claims against the trustee likewise are not core. However, that proposition is wholly untenable. The Ninth Circuit's decision rested squarely on the fact that debtor's president was a non-debtor being sued in his individual capacity. *See id.* at 1450 ("Here, the claims at issue are against Pierce, a nondebtor, in his individual capacity. The claims do not directly affect the estate or the confirmation of the estate's plan."). In contrast, the trustee, as an officer of the court charged with administering the estate, was intimately tied to the bankruptcy proceeding. Moreover, the trustee was not being sued in his individual capacity—the conduct at issue was the trustee's effort to enforce the automatic stay provision on behalf of the estate. Finally, even if there were ambiguity in the court's holding, that ambiguity has evaporated with the Ninth Circuit's holding in *Ferrante*, which indicates clearly that claims against trustees for official misconduct are core proceedings. The decision below does not conflict with *Cinematronics*.

Guild and Gallery also does not address the jurisdiction of the bankruptcy court to hear and decide claims of official misconduct by court-appointed persons. In that case, the debtor, prior to filing for bankruptcy, took possession of several paintings under a bailment contract. After the bankruptcy petition was filed, the owner of the paintings sought their return. One of the paintings was lost, leading to a

lawsuit against the bankruptcy trustee alleging negligence and conversion.

The Third Circuit held that the action was not a core proceeding based on the fact that the trustee's alleged impropriety involved property that never was part of the bankruptcy estate. 72 F.3d at 1173. As such, the alleged misconduct "a fortiori . . . cannot fall within §157(b)(2)(A), which can only be applied to matters concerning the administration of the bankruptcy estate." *Id.* The court in *Guild and Gallery* simply was not faced with the issue presented in this case and therefore the case does not conflict with the decision below.

While Southmark argues that "[m]any other conflicts flow from the uncertainty generated by *Marathon*," Pet. at 23, none of those alleged conflicts are implicated by the Fifth Circuit's fact-bound decision. On the issue raised in the instant case, there is no controversy. Each Court of Appeal addressing, either directly or indirectly, whether claims against court-appointed persons for alleged official misconduct constitute core proceedings has, like the Fifth Circuit, answered in the affirmative.

CONCLUSION

A bankruptcy proceeding is a unique process, and court-appointed professionals play an integral part in that process. In order to ensure that the process functions properly, bankruptcy courts must retain the authority to monitor and control the professionals they appoint. In recognition of this reality, the Fifth Circuit held that Southmark's allegations of misfeasance by Coopers in performing the official duties with which it was charged constituted a core proceeding within the meaning of the Bankruptcy Code and

Marathon. That holding comports with the decisions of this Court, as well as with the decisions of the other Courts of Appeals, and therefore Southmark's petition for a writ of certiorari should be denied.

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IN THE UNITED STATES BANKRUPTCY COURT FOR
DISTRICT OF TEXAS
DALLAS DIVISION

In re

SOUTHMARK CORPORATION,

Debtor.

Case No. 389036324-SAF-11

MOTION TO RECONSIDER AWARD OF FEES TO COOPERS & LYBRAND AND BRIEF IN SUPPORT THEREOF

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SOUTHMARK CORPORATION ("Southmark" or the "Debtor"), hereby submits its Motion to Reconsider Award of Fees to Coopers & Lybrand pursuant to Bankruptcy Rule 9024, incorporating Fed. R Civ. P. 60(b), and in support thereof shows the Court as follows:

STATEMENT OF FACTS

1. Southmark was organized in 1970 as a Maryland real estate investment trust. later known as Southmark Properties. In 1981, Gene E. Phillips and William S. Friedman acquired control of Southmark Properties and appointed themselves chairman and vice-chairman, respectively. Southmark Properties' headquarters was moved to Dallas, Texas, and on May 1, 1982, Southmark Properties was convened to a Georgia corporation and its name was changed to Southmark Corporation.

2. The principal business of Southmark was sponsoring private and publicly syndicated real estate partnerships. Through private and public borrowings, Southmark acquired other real estate companies, as well as a savings and loan association and insurance companies.

3. In April, 1989, fouowing two years of increasing financial distress, Southmark announced a $1 billion write-down of its asset values. This write-down wiped out Southmark's shareholders' equity, reducing equity from $604 million to negative $428 million. On July 14, 1989, Southmark filed a Chapter 11 bankruptcy proceeding in Atlanta. The case was subsequently transferred to Dallas. Under the plan of reorganization adopted by the Bankruptcy Court, holders of Southmark's more than one billion dollars in public debt received approximately five cents on each dollar of

their investment in cash, as well as securities in reorganized Southmark which could be worth as much as another 13 cents on the dollar.

4. From 1982 until shortly before Southmark's bankruptcy in 1989, Drexel Burnham Lambert ("Drexel") served as underwriter, broker and financial advisor to Southmark and several of its subsidiaries. Much of Southmark's dealings with Drexel were directly with the High Yield Department, run by Michael Milken. Through the High Yield Department Drexel was able to foster and sustain the illusion of a liquid market for issues of high yield corporate debt and preferred stock, which eventually and more accuratcly came to be known as "junk bonds." Underwriting junk bond issues and manipulating the junk bond markets earned Drexel exorbitant profits through underwriting fees, markups and trading profits.

5. Issuers of Drexel-underwritten bonds, such as Southmark, were forced through a variety of means to invest a portion of the issue proceeds in junk bonds underwritten by Drexel for other clients. Drexel clients who refused to invest in junk bonds found Drexel unwilling to underwrite further debt or preferred stock issues, which were frequently necessary just to retire maturing debt or redeem earlier preferred stock issues. Drexel clients who did not continue to purchase Drexel-underwritten bonds for their own portfolios also found Drexel unwilling to sell bonds the companies already owned.

6. Through the efforts of Drexel, Southmark raised well over a billion dollars through high-interest public debt issues, which quickly imposed a huge interest expense and principal repayment obligations on Southmark. The debt

incurred by Southmark was well in excess of the legitimate operational needs of the company. Southmark was induced by Drexel to invest the excess funds, over $400 million, in high-yield bonds of other Drexel clients. Southmark ultimately lost substantially in excess of $150 million on these junk bonds in 1988 and 1989. The crushing burden of debt service on junk bond issues, combined with devastating losses in its junk bond portfolio, contributed directly and substantially to Southmark's demise.

7. On July 28, 1989, shortly after it filed for bankruptcy, Southmark moved the Bankruptcy Court for the appointment of an Examiner, stating, "the Debtor believes that it is in the best interests of the estate and this Chapter 11 case to have a disinterested, independent individual review and investigate the pre-Chapter 11 activities of the debtor as they relate to third party transactions and relationships, and potential causes of action against such third parties on behalf of Southmark and the estate." Motion, ¶ 6. Southmark sought "an unbiased, independent assessment as to whether legal action by Southmark against various third parties, including any of its former officers and directors, is appropriate and should be pursued." Id. ¶ 9.

8. On September 8, 1989, the Bankruptcy Court issued an order approving the appointment of Neal Batson, a partner in the firm of Alston & Bird, as Examiner. The order charged the Examiner with the "investigation and review of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor, and ... making recommendations as to causes of action discovered in such investigation and review." The Court specifically authorized the Examiner to retain attorneys and accountants

to assist the Examiner in his investigation and review, with "the fees and expenses of such professionals to be paid from the estate upon proper application" On September 14, 1989, the Court approved the appointment of Alston & Bird as attorneys to assist the Examiner.

9. On September 26, 1989, the Examiner applied to the Court for an order authorizing the employment of Coopers & Lybrand as accountants to the Examiner, to investigate allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the pre-Chapter 11 affairs of the Debtor. The application is attached hereto as Exhibit A.

10. Attached to the application of the Examiner was an affidavit from David A. Carpenter, the engagement partner from Coopers & Lybrand. In paragraph 3 of that affidavit. Carpenter listed all "known connections" between Coopers & Lybrand and other parties in interest. Mr. Carpenter noted that "Coopers & Lybrand provides accounting and consulting services for Drexel in matters unrelated to this case." Mr. Carpenter did not indicate that Coopers & Lybrand's relations with Drexel would in any way impede or interfere with its duties as accountants to the Examiner

11. The appointment of Coopers & Lybrand was subsequently approved by the Court, pursuant to section 105(a) of the Bankruptcy Code, effective September 26, 1989. This Court noted that, "[w]hile the court could direct that the appointed examiner use the services of the committee's court-appointed accountant, that might defeat the objective of a disinterested examiner not associated with or serving creditors or equity security holders," In re Southmark Corporation, 113 BR. 280, 282 (Bankr N.D. Tex. 1990).

12. Most of the investigative work between September 26, 1989 and July 9, 1990, the date of the Examiner's final report, was performed by Coopers & Lybrand. Indeed, Coopers & Lybrand itself wrote substantial portions of the various interim and final reports filed by the Examiner.

13. On or about October 1, 1989, there was an initial meeting of the Coopers & Lybrand engagement team, which consisted of David Carpenter, Knute Kurtz (a new partner working under Carpenter), and a number of managers, including Selene Yu, David Kennedy, Steve Schocket and William Galbally. At that meeting, Carpenter assigned various members of the team to work on and investigate specific issues concerning the Southmark bankruptcy. Mr. Galbally was assigned to investigate issues including but not limited to possible avoidance claims that Southmark might have against Drexel arising, inter alia, out of Drexel's relationship as underwriter of bonds sold by Southmark and as broker of "high yield" bonds (i.e., payments by Southmark during the ninety days preceding the filing for bankruptcy that might be recoverable by Southmark).

14. Between October 2, 1989 and approximately December 4, 1989, Mr. Galbally worked on various litigation issues including possible claims against Drexel. As his work progressed, Mr. Galbally came to believe that Southmark's claims against Drexel were potentially the most significant and valuable of all the claims Southmark might pursue. In particular, Mr. Galbally believed that Southmark had substantial claims against Drexel in connection with Drexel's activities as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark. Prior to December 4, 1989, Mr. Galbally told Mr. Kurtz among

others, about the potential significance of the claims against Drexel.

15. On or about the night of December 4, 1989, Mr. Carpenter and Mr. Kurtz visited Mr. Galbally at the apartment in Dallas that Mr. Galbally shared with David Kennedy. According to Mr. Galbally, Mr. Carpenter asked Mr. Galbally what he (Galbally) had on Drexel. Mr. Galbally told Mr. Carpenter that Southmark's claims against Drexel were the most important in the engagement, that there appeared to be substantial misconduct by Drexel, and that Drexel had very deep pockets. According to Mr. Galbally, Mr. Carpenter became extremely angry and screamed repeatedly at Mr. Galbally. Mr. Carpenter told Mr. Galbally not to pursue the Drexel issues any further. Mr. Carpenter shouted at Mr. Galbally, among other things: "Don't [mess] with Drexel. Drexel is our largest audit client." When Mr. Galbally insisted that the Drexel issues had to be investigated, Mr. Carpenter told Mr. Galbally that he (Galbally) was being taken off the issues related to Drexel. Mr. Galbally was subsequently Sent to Atlanta to work on Southmark preference actions under the supervision of David Kennedy, even though Mr. Kennedy was Mr. Galbally's junior at Coopers & Lybrand. See Affidavit of William Galbally, attached hereto as Exhibit B.

16. On or about January 3, 1990, the potential claims against Drexel were reassigned to Jeffrey Kessler. Despite billing time to the Drexel matter, Mr. Kessler never developed a basis for claims against Drexel as identified by Mr. Galbally. On information and belief, Mr. Kessler, among others, knew why Mr. Galbally had been reassigned, and this knowledge effectively chilled any further Coopers & Lybrand investigation of the Drexel claims identified by Mr. Galbally.

17. On February 13, 1990, Drexel's parent, The Drexel Burnham Lambert Group, Inc. ("Drexel Group"), filed a petition for relief under chapter 1 1 of the Bankruptcy Code. The court in the Drexel Group bankruptcy set October 1, 1990 as the bar date for the assertion of pre-petition claims against Drexel Group,

18. On March 1, 1990, John C. Weitnauer of Alston & Bird, wrote to R. Paul Wickes, Thompson & Knight, to explain that Southmark might wish to pursue certain claims against Drexel in connection with the Examiner's review of potential preferential transfers, of which Drexel may have received $985,000 or more. Mr. Weitnauer's letter did not however, mention any potential claims Southmark might have against Drexel arising out of Drexel's activities identified by Mr. Galbally, including those as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

19. On April 17, 1990, Neal Batson sent a letter to R. Paul Wickes, Thompson & Knight (with copies to David Carpenter and Knute Kurtz) advising Thompson & Knight to pursue a "potential voidable preference paid to Drexel Burnham Lambert Incorporated ... within the ninety-day period prior to Southmark's Chapter 11 filing on July 14, 1989." In this letter, the Examiner specifically states that he and his experts "have not attempted to invesrigate" any "securities claims which Southmark may have as the purchaser of bonds underwritten or sold by Drexel." The Examiner also stated that "[i]n light of the plan requirement that the Examiner file his final report by the conclusion of the hearings on confirmation and the recent bankruptcy of the parent, we are not inclined to devote additional resources to a further investigation of any potential Southmark claims against Drexel." A

true and correct copy of the April 17, 1990 letter is attached hereto as Exhibit C.

20. On May 1, 1990, the Examiner filed his Fourth Interim Report (the "Report"). Despite the disclaimer in the Examiner's April 17 letter stating that he and his experts had not investigated claims which Southmark may have as the purchaser of bonds underwritten or sold by Drexel, this Report purported to deal with precisely those claims. The Report, which was written by Coopers & Lybrand. notes that "Southmark's access to the high-yield bond market was largely due to the efforts of Drexel" and that Southmark lost large amounts of money by buying on margin from Drexel a large portfolio of high-yield bonds. The Report then states that Drexel's role in these activities "was investigated more extensively [than other aspects of the Drexel relationship] because of the general, oft-repeated, potential charge that Drexel clients had to support the high-yield bond network."

21. The Report notes that "[p]ublic allegations involving Drexel and the support of the high-yield bond network revolve round allegations of Drexel's underwriting of high-yield bond issuances for companies with the understanding that the company would use part of the proceeds to purchase the high-yield bonds of other Drexel clients, thus helping to create what effectively would be a false market for these high-yield instruments." The Report, however, states at page 41 that proving these allegations was "made difficult by the facts." The Report states that any "ultimate proof" of Drexel's wrongdoing "must await examination of the involved parties." The Report goes on to note that "[s]uch examinations have not, and will not be a priority for the Examiner as any claims against Drexel Burnham Lambert and/or Michael Milken could be of limited value due to the

[Drexel bankruptcy] and [Milken's indictment on criminal charge]." The Report then states that the Examiner had specifically referenced these issues to Southmark's legal counsel. In fact, no such reference was ever made. True and correct copies of excerpted portions of the Fourth Interim Report are attached hereto as Exhibit D.

22. William Galbally read the portions of the Report dealing with Drexel before it was sent to the Examiner for his approval. According to Mr. Galbally, he told Mr. Kessler that the Report on Drexel was completely inadequate and that Coopers & Lybrand had an obligation either to investigate the Drexel issues fully and fairly or else to explain to the Examiner that, because of Drexel's status as a major audit client of Coopers & Lybrand. the firm had decided not to investigate Drexel. Mr. Galbally further told Mr. Kessler that the sort of self-serving disclaimer put in the Report, shifting the responsibility for investigation to counsel for Southmark, was improper. According to Mr. Galbally, Mr. Kessler responded that Mr. Carpenter wanted the Drexel issues handled this way and that he (Mr. Kessler) was not going to delve into the substance of those issues in the Report.

23. On July 9, 1990, the Examiner filed his Final Report. In the Final Report, which was also written by Coopers & Lybrand, Coopers & Lybrand provides yet another excuse for its failure fully to investigate potential claims against Drexel. Appendix I to the Final Report states that "[t]ime has not permitted a complete investigation into the awareness of... Drexel Burnham about the true financial condition of Southmark or the soundness of its business methods and operations. The Examiner has requested Southmark's counsel, Thompson & Knight to undertake the necessary

investigation into/and pursuit of any claims against Drexel Burnham While these outside professionals must have been aware of the specific actions they took, the Examiner has not evaluated their levels of knowledge and whether they fully appreciated how their actions may have produced and maintained the Southmark mirage." The Final Report acknowledges, however, that "'the Southmark mirage could not have been projected without the assistance, inadvertent or intentional, of these outside professionals." The Final Report then state that since Drexel filed for bankruptcy during the pendency of Southmark's bankruptcy, "the Examiner left to counsel for Southmark the necessary investigation into and pursuit of any claims against Drexel Burnham The Examiner does not know whether Southmark's counsel has taken any action in this regard." In fact, there was never any specific reference of claims against Drexel to Southmark's counsel, and Coopers & Lybrand never provided outside counsel for Southmark with any investigative material with respect to potential claims against Drexel. True and correct copies of excerpted portions of the Final Report are attached hereto as Exhibit E.

24. At no time during the course of Coopers & Lybrand's engagement on the Southmark bankruptcy did Coopers & Lybrand inform the Examiner, counsel for Southmark, or Southmark itself that Coopers & Lybrand was holding back from a full investigation of potential claims that Southmark might have against Drexel in order to protect Coopers & Lybrands lucrative audit engagement with Drexel.

25. At no time during the course of Coopers & Lybrand's engagement on the Southmark bankruptcy did Coopers & Lybrand inform the Examiner, counsel for Southmark, or Southmark itself that the Coopers & Lybrand

employee originally charged with investigating the Drexel claims believed, contrary to the Reports prepared for the Examiner, that Southmark had substantial claims against Drexel arising out of Drexel's activities as underwriter of bonds issued by Southmark and as broker for bonds purchased by Southmark.

26. Coopers & Lybrand failed to investigate claims against Drexel that one of its managers considered to be perhaps the most significant claims held by Southmark. According to that manager, who is still today a Coopers & Lybrand employee, the investigation was blocked due to a conflict of interest never disclosed to Southmark to the Examiner or to this Court. Indeed, upon information and belief, Mr. Carpenter went out of his way to convince the Examiner and his counsel that the Drexel audit relationship would not impair the thoroughness of the investigation of Drexel claims.

27. Beyond the failure to investigate (or to disclose why it could not investigate) Drexel claims, Coopers & Lybrand drafted the Examiner's Fourth Interim Report to suggest that it had dome some investigation of such claims and that such claims would be difficult to prove.

28. Southmark emerged from bankruptcy in August 1990. One of the first major decisions for reorganized Southmark was whether to engage outside professionals to investigate further claims against Drexel in order to be in a position to file a claim in the Drexel Group bankruptcy on or before the October 1, 1990 bar date imposed in that case. Due to a combination of factors including Southmark's limited liquidity at the time and the express and implicit lack of enthusiasm for such claims in the Examiner's report, Southmark

did not pursue a further investigation at that time and did not file a claim in the Drexel Group bankruptcy.

29. In early 1991, its coffers somewhat increased, Southmark engaged an outside law firm to investigate the Drexel claims for purposes of the possible filing of a claim against a fund set up by Mr. Milken to compensate defrauded Drexel investors. That investigation revealed the existence of claims virtually identical to the claims Mr. Galbally wanted to further investigate.

30. Southmark proceeded to file a claim against the Milken settlement fund for more than $600 million. Although negotiations are still ongoing, Southmark believes that the magnitude of its claim entitles it to a significant part of the $250 million in the Milken settlement fund. Had Southmark filed a claim in the Drexel Group bankruptcy - which it surely would have done had Mr. Galbally's theories been further investigated and disclosed - Southmark likely would have recovered many millions of dollars on that claim as well.

31. On or about March 5, 1991, this Court issued its Memorandum Opinion and Order on Final Applications for Compensation for Professional Persons and approved Coopers & Lybrand fees and expenses in this case in the approximate amount of $3.7 million.

32. In the early part of 1993, Southmark learned from a former Coopers & Lybrand employee that Mr. Galbally wanted to speak with Southmark about what had happened. Notwithstanding the obvious peril to his own career, Mr. Galbally told Southmark about the events that give rise to this motion. Since that disclosure, Southmark has had

a number of discussions with Coopers & Lybrand in an attempt to resolve this matter. Those discussions have not led to a resolution, and Southmark therefore brings this motion for determination by the Court of whether Coopers & Lybrand should be required to disgorge some or all of the fees previously awarded by the Court.

ARGUMENT

A. Jurisdictional Statement

33. This Court has jurisdiction over this Motion pursuant to 28 U.S.C. § 1334 and the plan of reorganization confirmed by this Court.

B. Introduction: Requirements For Employment Of Professionals In Bankruptcy

34. Professionals in the bankruptcy process owe a fiduciary duty, not only to the parties they represent, but also to the court. *In re Allegheny International Inc.*, 134 BR. 814, 820 (Bankr. W.D. Pa. 1991). "The professionals must be capable of proving that all actions taken are ethical and accomplished in good faith." *Id.*

35. In order to ensure that bankruptcy professionals live up to their fiduciary duty of good faith, the Bankruptcy Code sets forth certain employment and disclosure requirements. Section 327(a) of the Bankruptcy Code sets forth a two part test for the appointment of a professional person: (1) the professional may not hold or represent an interest adverse to the estate and (2) the professional must be a disinterested person. 11 U.S.C. § 327(a).

36. Additionally, Bankruptcy Rule 2014 sets forth the disclosure requirements for employment pursuant to Bankruptcy Code sections 327, 1103 or 1114. An application for the employment of a professional person requires disclosure "at any time during such person's employment" of, among other things, "all the professional's connections with the debtor, Creditor, any other party in interest, their respective attorneys and accountants." The statutory basis for denial of compensation is found in Bankruptcy Code section 328(c) which states that if, during the employment of a professional under sections 327 or 1103, a court determines that the professional is no longer disinterested or holds or represents an adverse interest the court may deny compensation for services and reimbursement of expenses. 11 U.S.C. § 328(c).

C. **Coopers & Lybrand Was Not Disinterested As Required By The Bankruptcy Code**

37. Section 101(14) of the Bankruptcy Code defines a disinterested person as one who:

> (A) is not a creditor, an equity security holder, or an insider,. . .
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connecton with, or interest in, the debtor or an investment banker . . . . or for any other reason

11 U.S.C. § 101(14)

38. In quoting *Collier*, the Fifth Circuit stated that the requirement of disinterestedness:

> Appears broad enough to include anyone who in the slightest decree might have some interest or relationship that would color the independent and impartial attitude required by the Code. ... Indirect or remote association or affiliations, as well as direct, may engender conflicting loyalties.

In re Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 (5th Cir. 1986) quoting 2 Collier on Bankruptcy § 327.03 at 327-19, 20(15th ed. 1985) (emphasis added).

39. The Fifth Circuit went on to say that Congress has determined that, due to the unique nature of the bankruptcy process, the employment of professionals in a bankruptcy case must be subject to strict standards. *Id* fn. 6, citing *In re Cropper Co.*, 35 B.R. 625, 629 (Bankr. M.D. Ga. 1983). Finally, on the subject of disinterestedness, the Fifth Circuit quotes language from *In re Philadelphia Athletic Club, Inc.*, which states as follows:

> Professionals engaged in the conduct of a bankruptcy case should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment

> expected of them during the course of administration.

Consolidated Bancshares, 785 F.2d at 1256, n.6, quoting *In re Philadelphia Athletic Club*, 20 B.R. 328, 334 (E.D. Pa. 1982) (emphasis added).

40. It is clear that applying the language of *Consolidated Bancshares* Coopers & Lybrand could not have been held to be disinterested if it had fully disclosed the nature of its relationships with Drexel. Coopers & Lybrand was not free of personal interest and its relationship with Drexel did in fact color the independent and impartial attitude required by the Bankruptcy Code.

41. Coopers & Lybrand will surely point to the fact that it did disclose the existence of the Drexel audit relationship. The nature of that disclosure, however, did not indicate that the Drexel relationship would impede or impair the investigation of claims against Drexel. And once Coopers & Lybrand had made the determination that it would not investigate these claims valued in the hundreds of millions of dollars, surely it had a duty to disclose this conflict to the Examiner, Southmark and the Court, particularly in light of the extensive role Coopers & Lybrand played in the investigation of third party claims,

42. Rather than disclose the conflict, Mr. Carpenter told the Examiner that there was no conflict. To add insult to injury, Coopers & Lybrand then expressly (by noting how difficult it would be to prove such claims) and implicitly (by running up millions of dollars in fees investigating far

less significant claims) downplayed the significance of such claims in conscious disregard to its duties in this case.

43. A similar issue was raised in In re Amdura where the court stated that the past representation of a former client does not create a conflict, unless the professional believes, that for any reason, it would not be able to "diligently and zealously" represent the debtor on the issue involving the former client. *In re Amdura*, 121 B.R. 862, 870 (Bankr. D. Colo. 1990). The court stated that if the former client is "not the band that feeds," and if the firm is not otherwise inhibited, the professional is not prohibited from acting as counsel. On the other hand, where the professional had openly declared an inability or unwillingness to "joust" with an ongoing client, the issues surrounding that client were pervasive, and the ongoing client was a multi-million-dollar-a-year client of the professional, the court stated that it found it difficult if not impossible, to find the professional disinterested. *Id.*

44. Drexel was indeed "the hand that feeds" Coopers & Lybrand and Coopers & Lybrand failed to openly declare to this Court its unwillingness to "joust" with Drexel. Coopers & Lybrand clearly displayed its inability to "diligently and zealously" represent Southmark on issues involving Drexel. In fact, the relationship between Coopers & Lybrand and Drexel perfectly mirrors the relationship in *In re Amdura* that the court found impossible to label disinterested. Coopers & Lybrand declared, albeit not openly, an unwillingness to "joust" with Drexel, the Drexel issues were pervasive and Drexel was a multi-million dollar client. Had this been disclosed to the Court, Coopers & Lybrand could not possibly have been deemed disinterested. Indeed, had the conflict been

disclosed to the Examiner, he almost certainly would not have sought to retain Coopers & Lybrand in the first instance.

D. Coopers & Lybrand Held An Interest Adverse To The Southmark Estate

45. Although the term "adverse interest" is not defined in the Bankruptcy Code itself, the following judicial definition has developed:

> (a) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or
> (b) to possess a predisposition under circumstances that render such a bias against the estate.

In re Diamond Mortg. Corp. of Illinois, 135 BR 78 94 (Bankr N.D. Ill. 1990): *In re Kuykendahl Place Associates, Ltd.*, 112 B.R. 847, 850 (Bankr. S.D. Tex. 1989); *In re Roberts*, 46 B.R. 815, 827 (Bankr. D. Utah 1985) *aff'd in relevant part and rev'd in part*, 75 B.R. 402 (D. Utah 1987); *Roger J. Au & Son, Inc. v. Aetna Ins. Co.*, 64 B.R. 600, 604 (N.D. Ohio 1986).

46. Under the judicial definition of adverse interest, Coopers & Lybrand clearly should have been disqualified from employment by the examiner. Coopers & Lybrand had a predisposition which rendered a bias against the estate in favor of its multi-million dollar client. Not only did it have

a predisposition it actually did "render such bias against the estate" in failing to vigorously pursue the Drexel claims.

47. The Supreme Court has held, in the context of a bankruptcy proceeding, that: "[w]here an actual conflict of interest exists, no more need be shown in this type of case to support a denial of compensation." *In re Woods v. City Nat. Bank & Trust Co.*, 312 U.S. 262, 268, 61 S.Ct. 493, 497 (1940). See also *Consolidated Bancshares*, 785 F.2d at 1256; *In re EWC, Inc.*, 138 B.R. 276, 280 (Bankr W.D. Okl. 1992); *In re Diamond Mortg. Corp. of Illinois*, 135 B.R. at 92; *In re Coay*, 122 B.R. 520, 526 (Bankr. N.D. Ohio 1990); *In re Micro-Time Management Systems, Inc.*, 102 B.R. 602, 606 (Bankr. E.D. Mich. 1989); *In re Kendavis Inc.*, 91 B.R. 742, 752 (Bankr. N.D. Tex. 1988). In other words, no showing of fraud or unfairness need be shown, in fact, nothing more than the conflict itself is required to be shown. Woods, 61 S.Ct. at 497.

48. The Supreme Court gives the following reason for not requiring any showing beyond the actual conflict:

> The incidence of a particular conflict of interest can seldom be measured with any degree of certainty. The bankruptcy court need not speculate as to whether the result of the conflict was to delay action where speed was essential, to close the record of past transactions where publicity and investigation were needed, to compromise claims by inattention where vigilant assertion was necessary or otherwise to dilute the undivided

> loyalty owed to those whom the claimant purported to represent.

Id.

49. As with the discussion of disinterestedness above, based upon Mr. Gallbally's sworn statements, there can be no genuine dispute as to whether Coopers & Lybrand had an actual conflict here. Plainly, it did. Accordingly, under either prong of section 327(a), Coopers & Lybrand was not qualified to work on behalf of Southmark and the Examiner.

E. Coopers & Lybrand's Failure To Disclose Mandates Disgorgement Of Its Fees

50. Pursuant to Bankruptcy Rule 2014 and its predecessor, the professional who seeks to represent the debtor must fully disclose at the time of the application for employment all connections with the debtor, creditors and other parties in interest. See *In re Arlin's Dept Stores, Inc.*, 615 F.2d 925, 931 (2d Cir. 1979); *In re Roberts*, 73 B.R. at 411; *In re Coastal Equities Inc.*, 39 B.R. 304, 308 (Bankr. S.D. Cal. 1984); *In re Diamond Lumber, Inc.*, 88 B.R. 773, 776 (N.D. Tex. 1988). All facts that may be relevant to a determination of whether a professional is disinterested or holds or represents an interest adverse to the debtor estate must be disclosed to the court. See, e.g., *In re Arlin*, 615 F.2d at 931-933; *In re Diamond Lumber*, 88 B.R. at 777, *In re Roberts*, 75 B.R. at 411; *In re Coastal Equities, Inc.*,39 B.R. at 308. The duty to disclose is broad because the court, rather than the professional, must decide whether the facts constitute an impermissable conflict of interest. See *In re Roberts*, 75 B.R. at 410-411; *In re Coastal Equities, Inc.*, 39 B.R. at 308; *In re Diamond Lumber*, 88 B.R. at 777.

51. The duty to disclose is not only predicated on the statutory requirements of Rule 2014, but also the obligation to disclose in the capacity as an officer of the court and fiduciaries. *In re Coastal Equities*, 39 B.R. at 308.

52. Professionals, when making disclosure, are on notice that if the disclosure is inadequate, if the facts are incorrect or if the changing facts and circumstances reveal an actual conflict, and the professional is later proved to be interested, the court is empowered to deny or reduce fees. *In re Sky Valley, Inc.*, 135 B.R. 925, 935 (Bankr. N.D. Ga. 1992). See also *In re EWC, Inc.*, 138 B.R. at 282 ("[p]rofessionals employed for the estate are under a continuing duty to disclose their connections."): *In re Diamond Mortg. Corp.*, 133 B.R. at 90. Furthermore, if the duty to properly disclose is neglected, however innocently, the professional performs the duties to the estate at its peril. *In re Coastal Equities*, 39 B.R. at 308.

53. Many courts have held that failure to comply with the disclosure requirement is an independent basis for denial of all fees under 11 U.S.C. Section 328, The court in *In re EWC, Inc.*, stated as follows:

> Therefore, if, a person has at any time during employment by the estate, any connections with the debtor, creditors, any other party in interest, their attorneys and accountants, . . ." pursuant to Fed. R.Bankr.Pro. 20 14(a), and fails to disclose those 'connections' to the best of his or her knowledge, it is necessary and appropriate that employment of that

> person must be set aside to carry out the provisions of the Bankruptcy Code. Any request for compensation must be denied, and any compensation received must be disgorged.

138 B.R. 276, 280-281 (Bankr. W.D. Okl. 1992). *See also Consolidated Banchsares*, 755 F.2d at 1256 n. 7; *In re Roberts*, 75 B.R. at 412; *In re Coastal Equities*, 39 B.R. at 308; *In re Thompson*, 54 B.R. 311, 316 (Bankr. N.D. Ohio 1983); *In re Marine Outlet, Inc.*, 135 B.R. 154, 156 (Bankr. M.D. Fla. 1991) ("failure to comply with the mandate of Bankruptcy Rule 20 14(a) merits a total forfieture of all fees"); *In re Tinley Plaza Associates. L.P.*, 142 B.R. 272, 278 (Bankr. N.D. Ill. 1992) ("if an attorney does not disclose a conflict arising after employment has been allowed, the court must . . . disgorge any compensation granted during the period the conflict existed"); *In re Micro-Time*, 102 B.R. at 608 (all compensation was denied the trustee and accountant because, had they fully disclosed they would not have been appointed and thus they have nothing on which to base their claim for compensation, despite substantial contribution). Contra *In re Roberts*, 75 B.R. at 412 ("where equities outweigh the need for attorney discipline for failure to disclose potential conflicts, the law does not require the denial of fees and costs"). The court in *In re Micro-Time*, in referring to the complete denial of fees, stated:

> The argument that possible harm . . . could be counter-balanced by greater benefit [to the estate] does not cover the policy considerations which look to the harm to representation, the loss of confidence, etc. Moreover, [i]t is almost

> impossible for a court to determine what benefit has accrued to the estate as opposed to what detriment might have accrued...absent a conflict of interest....

In re Micro-Time, 102 B.R. at 608.

54. Although Coopers & Lybrand disclosed the existence of its relationship with Drexel, it failed to disclose the significance of that relationship and the potential impact on its duties as the accountant to the Court appointed examiner. While this Court endeavored to employ a disinterested examiner to diligently review the potential claims of the estate, Coopers & Lybrand failed to disclose its predisposition to protect its relationship with Drexel and thus tainted the disinterestedness of the Examiner. As noted in *In re Micro-Time*, in hindsight it is impossible for this Court to determine what benefit might have accrued to the estate absent this conflict of interest and what detriment did in fact accrue.

F. **This Motion To Reconsider Is Timely Under Rule 60(B)**

55. Rule 60(b) of the Federal Rules of Civil Procedure, through the operation of Bankruptcy Rule 9024, governs both the rounds and the time limitations for a motion to reconsider a bankruptcy court order.

56. Rule 60(b) provides that:

> [o]n motion and upon such terms as are just, the court may relieve a party or a party's legal representative from a final

> judgment, order, or proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of the judgment. The motion shall be made within a reasonable time, and for reasons (1), (2), and (3) not more than one year after the judgment, order, or proceeding was entered or taken. A motion under this subdivision (b) does not affect the finality of a judgment or suspend its operation. This rule does not limit the power of a court to set aside a judgment for fraud upon the court...

Fed. R. Civ. P. 60(b) (emphasis added). As is evident from the language of the Rule itself, Rule 60(b)'s one year time limitation for bringing a motion to reconsider does not apply to (a) Rule 60(b)(6) ("any other reason justifying relief from the operation of a judgment"), or (b) fraud upon the court.[1]

57. **Rule 60(b)(6):** The purpose of Rule 60(b)(6), which provides relief from a judgment for "any other reason justifying relief", is to prevent extreme hardship or injustice. *See United States v. McDonald*, 86 F.R.D. 204, 208 (N.D. Ill. 1980). Once hardship or injustice is found, "Rule 60(b)(6) is to be liberally applied to 'accomplish justice.'" Id. In the Fifth Circuit, Rule 60(b)(6) applies where "something more" than mistake, fraud or newly discovered evidence is shown. *See, e.g., Bros. Inc. v. W.E. Grace Mfg. Co.*, 320 F.2d 594, 608-09 (5th Cir. 1963) (Rule 60(b)(6) invoked upon showing of "something more" than mere plea to reopen based upon newly discovered evidence or fraud).

58. Here, Coopers & Lybrand committed fraud by failing to disclose that its substantial relationship with Drexel would preclude its vigorous investigation of claims against Drexel. However, Coopers & Lybrand's activities (as developed more fully herein) go far beyond mere fraud. Here, the "something more" arises from the context of Coopers & Lybrand's misconduct, i.e. Coopers & Lybrand's fiduciary status with respect to the Court, its affirmative duty to

---

[1] Both of these exceptions to Rule 60(b)'s one year time limitation appear, based upon the language of the Rule, to apply only to judgments as opposed to orders; however, case law interpreting Rule 60(b) does not support such a rigid interpretation. *See Lucas v. City of Juneau*, 20 F.R.D. 407, 410 (D. Alaska 1957) (Rule 60(b)(6) applies to order as well as judgment); *In re H.B. Michelson*, 141 B.R. 715, 725-26 (Bankr. E.D. Cal. 1992) (fraud on the court is basis for revoking order confirming reorganization plan). Moreover, even if the Rule 60(b)(6) and the fraud upon the court exceptions apply only to judgments, these exceptions still apply under the presented facts since Bankruptcy Rule 9002 defines "judgment", as it is used in the Federal Rules of Civil Procedure including Rule 60(b), to include "any order appealable to an appellate court." Because the order of this Court approving Coopers & Lybrand's fee is an appealable order, it is also a "judgment" pursuant to Bankruptcy Rule 9002.

disclose any potential conflicts of interest to the Court, the requirement of disinterestedness and, most important, the public interest in seeing that the creditors of Southmark are treated fairly and equitably. Shielding one of its largest clients from claims that could have substantially enhanced creditor recoveries was plainly inimical to the interests of Southmark's creditors and a violation of Coopers & Lybrand's fiduciary and statutory duties. Moreover, this type of misconduct threatens the very integrity of, and the public trust in, the bankruptcy process. Consequently, the Court must reconsider its order award of fees to Coopers & Lybrand pursuant to Rule 60(b)(6).

59. **Fraud upon the Court**: Like a motion brought pursuant to Rule 60(b)(6), a motion to reconsider based on fraud upon the court is not subject to the one year time limitation of Rule 60(b). Fed. R. Civ. P. 60(b). "Fraud upon the court" is fraud committed by an officer of the court which affects the judicial machinery in such away "that the judicial machinery cannot perform in the usual manner its impartial task of adjudging cases that are presented for adjudication." *Browning v. Navarro*, 826 F.2d 335, 344-45 n. 12 (5th Cir. 1987); *Budge v. Post*, 544 F. Supp. 370, 377 (N.D. Tex. 1982). The Examiner is an officer and fiduciary of this Court. *See In re Baldwin United Corp.*, 46 B.R. 314, 318-17 (Bankr. S.D. Ohio 1985) (examiner, as non-adversarial officer o the court, operates as a civil grand jury "to ascertain legitimate areas of recovery" for the estate). By concealing the extent of its relationship with Drexel and by failing to develop claims against Drexel. Coopers & Lybrand tainted the Examiner's Interim Reports, and committed a fraud upon this Court. Moreover, Coopers & Lybrand, as court-appointed accountants, were quasi-officers and fiduciaries of this Court. See *In re Food Town, Inc.*, 208 F. Supp. 139, 148-49 & n.6 (D. Md.

1962). By concealing the effect of its relationship with Drexel on the work it was charged to perform and by failing to investigate and/or covering up Southmark's claims against Drexel, Coopers & Lybrand perpetrated a fraud upon both the Court-appointed Examiner and this Court.

60. Consequently, this Motion is not time barred by the one year limitations period set out in Rule 60(b).

CONCLUSION

61. Coopers & Lybrand's failure to disclose its disinterestedness and adverse interest resulted in the very type of injury to the estate that the strict requirements of the Bankruptcy Code seek to avoid. Coopers & Lybrand failed to vigorously pursue certain actions against Drexel creditors. Complete disgorgement here is necessary and appropriate (a) in light of the harm caused Southmark by the Coopers & Lybrand misconduct and (b) to serve as a warning to other professionals that the requirements under the Bankruptcy Code are to be taken seriously and that misleading partial disclosures of conflicts of interest will not be tolerated. Accordingly, Southmark respectfully requests that the Court reconsider the previous award of over $3.7 million in frees and expenses to Coopers & Lybrand and order Coopers & Lybrand to fully disgorge all such fees and expenses to Southmark.

DATED: January 4, 1994.

Respectfully Submitted,

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UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

IN RE: VYTAUTAS VEBELIUNAS, Debtor

Chapter 7, Case No. 98 B 45466 (TLB)

March 10, 1999, Decided

COUNSEL: Edgar H. Booth, Esq., Donald L. Kuba, Esq., Warren R. Graham, Esq., WARSHAW BURSTEIN COHEN, SCHLESINGER & KUH, L.L.P., New York, New York, for Chapter 7 Trustee.

ROY BABITT, ESQ., Chapter 7 Trustee, New York, New York.

VYTAUTAS VEBELIUNAS, Debtor, Pro se, Richmond Hill, New York.

Alan E. Gamza, Esq., MOSES & SINGER, L.L.P., New York, New York, for Citibank, N.A.

TRACY HOPE DAVIS, ESQ., Office of the United States Trustee, New York, New York.

JUDGES: HONORABLE TINA L. BROZMAN, CHIEF UNITED STATES BANKRUPTCY JUDGE.

OPINION BY: TINA L. BROZMAN

OPINION: OPINION DISQUALIFYING COUNSEL TO CHAPTER 7 TRUSTEE

HONORABLE TINA L. BROZMAN

CHIEF UNITED STATES BANKRUPTCY JUDGE:

Concerns and fears of partisan bias in the House of Representatives and in the voting by Senators rocked the impeachment process of President William Jefferson Clinton. As it turned out, once the Senators viewed the evidence and gave it the weight they deemed appropriate, they did not vote along unified party lines but acquitted the President. I mention this only to illustrate what a destructive force bias can be if it is allowed to go unchecked and how important in the judicial and quasi-judicial arenas it is first to amass reliable evidence and only then to formulate an opinion.[1] In fact, the point in time when an opinion is formed is essential to the distinction between bias on the one hand and reasoned judgment on the other. Today, I address that very issue as it relates to the disinterestedness of counsel to the chapter 7 trustee on account of his clear expression of prejudice against the debtor before any § 341 or other examination of him by the trustee.

I.

A. Procedural History

Vytautas Vebeliunas, the debtor pro se in this converted chapter 7 case, moved to disqualify Roy Babitt, the chapter 7 trustee assigned to his case, by reason of an alleged conflict of interest arising out of a prior representation of the debtor's affiliate by the firm where Mr. Babitt is of counsel but which does not represent him in this matter. In a decision issued

from the bench, I held that there was absolutely no basis in law or fact warranting the trustee's disqualification for a conflict of interest or for any other reason, however, I instructed the trustee to engage substitute counsel because it had become apparent from the pleadings that his counsel, specifically Warren Graham of Warshaw Burstein Schlesinger & Kuh ("Warshaw Burstein"), was not disinterested as required by § 327(a) of title 11 of the United States Code (the "Bankruptcy Code"). Warshaw Burstein expressed shock at my ruling, not only because the firm clearly did not appreciate it,[2] but because it claims it was not put on notice that I was going to raise and address what was in the papers but what the debtor did not address during his oral argument. Being a firm believer in due process and not wishing to deprive anyone of his or her right to be heard, I allowed Warshaw Burstein to respond in writing and then orally at a subsequent hearing.[3] I did this despite the fact that I regarded the issue of counsel's disinterestedness to be sufficiently glaring from the papers submitted that adequate and sufficient notice of its existence was provided. However, that is only my opinion and reasonable minds do differ.

B. Background

1. The Lattingtown Question

Vebeliunas may or may not own a piece of property located in Lattingtown, New York, which was last valued at $ 4.5 million. When he filed his chapter 11 petition, Vebeliunas did not schedule the property, taking the position instead that it is owned by a trust in which he has a 20% interest. Several

banks with liens against the property totaling less than $ 2 million moved to dismiss the chapter 11 case, asserting that Vebeliunas did indeed own the property but that they could pursue foreclosure in state court. Instead, because Vebeliunas may have significant unsecured debt which, if the Lattingtown property is his, possibly could be satisfied in whole by his equity in that property, I converted the case to a chapter 7 liquidation, noting that the trustee was to examine into the ownership question. Roy Babitt was appointed chapter 7 trustee, with Warshaw Burstein being retained as his counsel.

2. The Telephone Call With Monica Setikas

Prior to the debtor's scheduled § 341 examination,[4] Vebeliunas' assistant, Ms. Monica Setikas, telephoned Graham requesting information about the upcoming meeting. Her reason for calling, she claimed, was that Vebeliunas had not received timely notice of it and that the notice he finally did receive contained inaccurate information. In response to her request, Graham allegedly told Ms. Setikas that he did not believe "anything the debtor said in this case," that he was getting a court reporter and that Vebeliunas had better be at the meeting. This conversation was first brought to the court's attention in Vebeliunas' papers moving for the trustee's disqualification. See Vebeliunas Moving Affidavit, P15. In his papers opposing the debtor's motion, Graham recounts the same exchange as follows:

> The Debtor's suggestion in paragraph 15 of the Vebeliunas Affidavit that "Mr. Babitt, without ever speaking to [him], has instructed his

> attorneys not to believe [him]," is also without any factual basis. The Debtor's motion papers then go on to detail a conversation between Monica Setikas, an associate of the Debtor, and Warren R. Graham, a member of the Warshaw Burstein firm, and the author of these papers, quoting Mr. Graham as stating that he "did not believe anything Mr. Vebeliunas said in this case." While that quote is substantially accurate, the skepticism contained therein is entirely predicated on the record and the gross inconsistency of the Debtor's position concerning ownership of the property, with among other things, his previous sworn statements."[5]

See Trustee's Opposition, P19 (emphasis added). However, at the hearing, Graham testified that he did not remember the conversation with any specificity; with respect to his comment expressing his disbelief of Vebeliunas, Graham said he thought that he made that remark in connection with Vebeliunas claims of deficient notice. In their papers moving for reconsideration, neither the firm nor Graham makes any statement reflecting this position. In fact and significantly, the firm's and Graham's affidavits in opposition to disqualification continue to recount Graham's remark to Monica Setikas as one expressing disbelief of anything the debtor had to say in the case generally. See Warshaw Burstein Affidavit in Opposition to Disqualification, P12; Graham Affidavit Annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P7. In paragraph 7 of Graham's affidavit, he goes through a detailed list of reasons, only one of which was the repeated claim of deficient notice, why "in frustration and exasperation, [he] spontaneously remarked that [Graham] did not believe anything [Vebeliunas] said." Graham Affidavit

Annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P7. If Graham had wished to clarify the context in which he remarked on the debtor's credibility, he had several opportunities to do so before the de novo hearing. But he did not. Had Graham not changed his story when he testified, it would have been unnecessary to make a credibility determination. But I believe I have no other choice now other than to render such a determination. I find Graham's testimony at the hearing to have been evasive and not credible.

In the most recent brief submitted by Warshaw Burstein in opposition to its disqualification, Warshaw Burstein attempts to justify Graham's conclusions about the debtor by stating:

> it is respectfully urged upon this court that when a debtor swears to directly contrary facts on numerous occasions and transfers the same piece of property numerous times outside the chain of title, it is not essential for the Trustee, or his counsel, to "get his side of the story" prior to concluding that he has no credibility.

See Warshaw Burstein Affidavit in Opposition to Disqualification, P27. Graham also suggested that his frustration and exasperation with the debtor[6] "together with the Debtor's status as a convicted felon [which] gave [Graham] ample justification to doubt [Vebeliunas'] credibility, and did not impose upon [Graham] an additional duty 'to get his side of the story.'" See Graham Affidavit annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P8. Notwithstanding Graham's statements, Vebeliunas has contended in court papers that the other parties in interest misapprehend

the facts relating to the chain of title of the property and Vebeliunas further says that he has an explanation to support his own view of the documents to which Graham has referred.

II.

Counsel's compliance with the disinterestedness requirement under § 327(a) not only applies at the time of retention but also throughout the case, see In re Granite Partners, L.P., 219 B.R. 22, 32 (Bankr. S.D.N.Y. 1998); Rome v. Braunstein, 19 F.3d 54, 62 (1st Cir. 1994), and is so crucial to the proper functioning of the bankruptcy system that a court may raise it and dispose of it whenever its sanctity is questioned. See In re Martin, 817 F.2d 175, 180 (1st Cir. 1987) (discussing the bankruptcy court's fundamental responsibility to monitor the integrity of the proceedings before it); In re Plaza Hotel Corporation, 111 B.R. 882, 891 (Bankr. E.D. Cal. 1990) (the court has a continuing supervisory role during the case which includes the ability to revisit issues such as disinterestedness whenever appropriate); Booth v. Continental Insurance Company, 167 Misc. 2d 429, 634 N.Y.S.2d 650, 653-654 (Sup. Ct. West. Co. 1995) (citing Wagenheim v. Pomerantz, N.Y.L.J. 7/7/70, p.13, col.7 at p. 14, col.1 (Sup. Ct. West. Co.) (citing cases) ("the judiciary will not close its eyes when the suggestion of impropriety appears on the record and the issue may be raised sua sponte"); In re Kelton Motors, Inc., 109 B.R. 641, 650 (Bankr. D.Vt. 1989); see generally Flushing Savings Bank v. FSB Properties, Inc., 105 A.D.2d 829, 482 N.Y.S.2d 29, 31 (App. Div. 1984). If there was any infirmity in my issuing my prior ruling without advising the firm that I was considering its removal, that infirmity has been cured by the leave I subsequently granted Warshaw Burstein to appear and be heard on this issue. See Kelton Motors, 109 B.R. at 650.

The crux of Warshaw Burstein's argument is that neither the trustee nor trustee's counsel need be disinterested vis-a-vis the debtor and that counsel had no duty to question the debtor before concluding that he is completely untrustworthy. Further, Warshaw Burstein argues, Graham was entitled to disbelieve the debtor pre-examination without compromising counsel's disinterestedness should I find that that standard applies to the firm.

III.

I feel compelled to first put to bed any doubt as to Graham's bias and how I reached the conclusion that he possessed one. The pertinent facts are simple. Prior to any examination of the debtor by the trustee or his counsel in connection with the chapter 7 case, Graham made an unequivocal statement to the effect that he believed Vebeliunas to be a liar. In his affidavits, Graham manifested a further belief that the debtor did not deserve the opportunity to explain himself because he is a convicted felon. See Graham Affidavit annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P8. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY defines prejudice as "a preconceived judgment or opinion" and "an opinion or leaning adverse to anything without just grounds or before sufficient knowledge." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (Merriam-Webster, Springfield Mass. 1981). The same source defines bias as "such prepossession with some object or point of view that the mind does not respond impartially to anything related to this object or point of view."[7] Id. While Vebeliunas may turn out to be guilty, as alleged, of supplying misinformation to the parties in interest, Graham simply cannot have

concluded that Vebeliunas is lying absent a bias or prejudice on Graham's part because there has not been an examination of Vebeliunas, and, therefore, the totality of evidence needed for Graham to have formed a reasoned judgment is not yet available. Quite obviously Graham is biased against the debtor, for when Ms. Setikas merely requested information for Vebeliunas, Graham responded by attacking the debtor's credibility, thereby demonstrating a complete lack of impartiality with respect to anything having to do with him.

Warshaw Burstein and Graham contend that the comments to Ms. Setikas about the debtor were perhaps "impolitic" but not serious enough to raise a question as to counsel's disinterestedness. An impolitic remark is an unwise remark. See id. During his conversation with Ms. Setikas, had Graham quipped "Vebeliunas probably threw out the notice I sent him," that would have been an unwise and inappropriate remark, but not one indicating bias or prejudice. However, telling a debtor's representative that you don't believe a word the debtor says before you have spoken with the debtor is significantly more troubling. It indicates a predisposition not to trust, listen to, believe in or have confidence in that person.

I recognize that, factually at least, this case is unique, unlike any other reported decision. Whereas most of the decisions regarding the propriety of the retention of counsel involve a conflict of interest, this case admittedly does not address an actual, potential or apparent conflict; the debate that surrounds disqualifying conflicts of interest is not implicated here. Jurisprudential precedent on this topic therefore may only serve to guide me as I make inroads into what amounts to be pristine territory. See Board of Education of the City of New York v. Nyquist, 590 F.2d 1241, 1246 (2d Cir. 1979) (quoting Fund of Funds, Ltd. v. Arthur Andersen & Co., 567 F.2d 225, 227 (2d Cir. 1977)).

IV.

The Bankruptcy Code sets forth a two-pronged test for the retention of estate professionals. See 11 U.S.C. § 327(a); 11 U.S.C. § 101(14). In order for the trustee to retain professionals to represent or assist him or her in carrying out the duties spelled out under § 704 of the Bankruptcy Code, those professionals must meet both requirements. See Martin, 817 F.2d at 180; Granite, 219 B.R. at 32; In re Envirodyne Industries, Inc., 150 B.R. 1008, 1016 (Bankr. N.D.Ill. 1993). First, § 327(a) authorizes the trustee, with the court's approval, to employ "one or more attorneys ... that do not hold or represent an interest adverse to the estate;" and second, "that are disinterested persons." 11 U.S.C. § 327(a). The "adverse interest" element in § 327(a) is undefined by the Bankruptcy Code but has been judicially fashioned to mean either (1) the possession or assertion of any economic interest that would tend to lessen the value of the bankruptcy estate or create an actual or potential dispute with the estate as a rival claimant, or (2) a predisposition of bias against the estate. Kravit, Gass & Weber, S.C. v. Michel (In re Crivello), 134 F.3d 831, 835-36 (7th Cir.1998); Smith v. Marshall (In re Hot Tin Roof), 205 B.R. 1000, 1003 (B.A.P. 1st Cir. 1997); Granite, 219 B.R. at 33; Envirodyne, 150 B.R. at 1016-17; In re Roberts, 46 B.R. 815, 827 (Bankr. D. Utah 1985) aff'd in part, modified in part and rev'd in irrelevant part, 75 B.R. 402 (D. Utah 1987). We are unconcerned here with § 327(a)'s first prong, no adverse interest, but are more concerned with disinterestedness, the second prong, because the bias exhibited is against the debtor, rather than the estate.

Unlike the "adverse interest" prong of the test, disinterestedness is delineated in the Bankruptcy Code. So far as relevant here, § 101(14)(E) of the Bankruptcy Code, more commonly known as the catch-all clause, see Granite, 219 B.R. at 32; 3 L. King, COLLIER ON BANKRUPTCY, P327.04[4][e] at 327-43 (15th ed. rev. 1996), defines a disinterested person as one that "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason." 11 U.S.C. § 101(14)(E) (emphasis added); see In re Marvel Entertainment Group, Inc., 140 F.3d 463, 476 (3d Cir. 1998) ("One is a 'disinterested person' only if he [or she] has no interest that is materially adverse to a party in interest in the bankruptcy."). It is well-recognized that the meaning of the phrase "interest materially adverse" in the definition of a disinterested person overlaps with that of "interest adverse" in the first prong of § 327(a) and together, they form one hallmark with which to evaluate whether professionals seeking court-approved retention (or to remain retained by the estate) meet the absence of adversity requirements embodied in the Bankruptcy Code. See Martin, 817 F.2d at 180; Hot Tin Roof, 205 B.R. at 1003; Granite, 219 B.R. at 33; In re Leslie Fay Cos., 175 B.R. 525, 532 (Bankr. S.D.N.Y.1994); Envirodyne, 150 B.R. at 1017.

Warshaw Burstein does not deny that it must be disinterested but takes issue with whether it must be so vis-a-vis the debtor, since the latter is not named in the statute. See 11 U.S.C. § 101(14)(E). Only if I determine that the debtor is owed such a duty need I address the second question, which

is whether Graham's bias constitutes a lack of disinterestedness under the second prong of § 327(a).

A. Must Warshaw Burstein Be Disinterested As To The Debtor?

1. The Debtor As A Potential Equity Security Holder

Counsel's obligation to be disinterested runs to the parties in interest. See Marvel, 140 F.3d at 476. In the typical case, the debtor has no standing to be heard on many matters not involving the discharge of debt because the outcome is irrelevant to the debtor when the estate will not generate a surplus. However, cases discussing a chapter 7 debtor's right to be heard when he or she retains an equity interest in the estate hold that the debtor has standing to lodge an objection to a claim against the estate or to participate in litigation surrounding the asset that stands to produce the surplus. See 4 L. King, COLLIER ON BANKRUPTCY, P502.02[2][c] at 502-14 (15th ed. rev. 1996) (debtor is a party in interest and has standing to object to a claim where there could be a surplus after all claims are paid); In re Manshul Construction Corp., 223 B.R. 428, 430 (Bankr. S.D.N.Y. 1998); In re McCorhill Publishing, Inc., 89 B.R. 393, 396 (Bankr. S.D.N.Y. 1988) (in a liquidation under chapter 7, a debtor has standing to object to claims where disallowance of the claims would produce a surplus); In re Sobiech, 125 B.R. 110, 113 (Bankr. S.D.N.Y. 1991); In re Silverman, 10 B.R. 734, 735 (Bankr. S.D.N.Y. 1981), aff'd 37 B.R. 200 (S.D.N.Y. 1982). In In re Gulph Woods Corporation, 116 B.R. 423 (Bankr. E.D. Pa. 1990), the receiver for the plaintiff in an adversary

proceeding commenced against the debtor sought to prevent the debtor from participating in litigation regarding the sale of property of the estate. The receiver argued that the only interest the debtor could have would be a residuary one under § 726(a)(6), which is not an independent interest and therefore unable to confer standing on the debtor to assert a claim against the receiver. The court held that standing in bankruptcy cases is unlike standing in other cases and that "a debtor may participate in litigation if that litigation will generate or protect a surplus in the estate." Id. at 428. In interpreting Silverman, a case from this district which ultimately denied the debtor's request for standing to object to a claim against the estate because the court determined that no surplus would be generated from the claim's disallowance, the Gulph Woods court explained that "the [Silverman] court's language clearly implied that, if the debtor could have shown that there may have been a surplus for his estate, he would have had standing, independent of trustee [sic], to object to the claim in question." Id. at 428-29 (emphasis added).

Pursuant to § 726(a)(6), if all of Vebeliunas' obligations are satisfied, he will be entitled to any surplus proceeds generated by the liquidation of the Lattingtown property.[8] Thus, this debtor should be considered a party in interest, see COLLIER, P502.02[2][c] at 502-14; McCorhill, 89 B.R. at 395 (debtor is a party in interest where he or she will retain a pecuniary interest in the equity of the estate if all the creditors can be paid in full); In re Hutchinson, 5 F.3d 750, 756 (4th Cir. 1993) (party in interest is generally understood to include all persons whose pecuniary interests are affected by the bankruptcy proceedings); In re James Wilson Assoc., 965 F.2d 160, 169 (7th Cir. 1992) (everyone with a claim to the res has a right to be heard before the res is disposed of since that disposition will extinguish all such claims), the legal consequence of which is that Graham ought be disinterested

vis-a-vis Vebeliunas because he is, for all intents and purposes, the potential class of equity security holders under 11 U.S.C. § 101(14)(E). There is no method of protecting Vebeliunas later while a non-disinterested professional is presently in charge of the investigation, should Vebeliunas prove to be the class of equity holders. The only protection can be given now. But the broader point, despite the statute's reference to equity security holders rather than debtors,[9] is that the trustee's professionals cannot be allowed under any circumstances to lack disinterestedness through bias against a debtor given the responsibilities of the trustee in regard to a natural debtor, specifically, to examine into and object to inappropriate proofs of claim (which can inure to a debtor's benefit if the claim is not dischargeable or if there may be a surplus); to investigate into the debtor's financial affairs; if advisable, to oppose the debtor's discharge; and, if there be a surplus, to deliver it to the debtor. See 11 U.S.C. §§ 704(4), (5) and (6) and 726(a)(6).

2. "Or For Any Other Reason"

Separate and apart from whether or not Vebeliunas can be considered tantamount to an equity security holder under § 101(14)(E), there is a strong argument to be made that the "or for any other reason" language at the end of that subsection is intended, as noted by Collier, [10] to permit "the court to find a particular person lacking in disinterestedness for reasons other than the non-exclusive statutory guidelines." Roberts, 46 B.R. at 828 n.26 (citing In re Philadelphia Athletic Club, Inc., 20 B.R. 328, 333 (E.D. Pa. 1982) (quoting I COLLIER BANKRUPTCY MANUAL § 101.13 (1981))). The oft-quoted language [11] that "professionals engaged in the conduct

of a bankruptcy case should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment expected of them during the course of administration," [12] lifted from the COLLIER BANKRUPTCY MANUAL excerpt quoted in Philadelphia Athletic Club and Roberts is the manual's conclusion of the function and effect of the "or for any other reason" clause as it affects the meaning of disinterestedness. COLLIER BANKRUPTCY MANUAL § 101.13. Under this view, the definition of disinterestedness pursuant 11 U.S.C. § 101(14) is not exclusive and is an attempt, albeit not a very clear one from the drafting perspective, to allow a court to reject an attorney if it "deems a particular person's associations to be prejudicial to disinterestedness ... even though those associations do not come within the purview of section 101(13)." Id. Although the Second Circuit has not passed on this issue, other Circuits have implicitly endorsed this view by quoting Roberts (and hence the COLLIER BANKRUPTCY MANUAL) when defining disinterestedness. See Crivello, 134 F.3d at 835 (citing In re BH&P, Inc, 949 F.2d 1300, 1308 (3d Cir. 1991) (citing In re BH & P, Inc. 119 B.R. 35, 42 (D.N.J. 1990) (citing In re Glenn Electric Sales Corp., 99 B.R. 596, 601 (D.N.J. 1988) (quoting Roberts, 46 B.R. at 828 n.26)))) (the catch-all clause is sufficiently broad to include any professional with an "interest or relationship that would even faintly color the independence and impartial attitude required by the Bankruptcy Code); Winship v. Cook (In re Cook), 223 B.R. 782, 789 (B.A.P. 10th Cir. 1998) (quoting BH&P, 949 F.2d at 1309 (quoting Roberts, 46 B.R. at 828 n.26))(same). Under this broad view, Graham is required to be disinterested with respect to the debtor regardless of whether or not Vebeliunas is a potential equity security holder.

B. Standards of Disinterestedness

Courts examine the goals and purposes of the disinterestedness requirement in order to understand the full contours of that concept. To be disinterested is "to prevent even the appearance of a conflict irrespective of the integrity of the person or firm under consideration." In re Codesco, 18 B.R. 997, 999 (Bankr. S.D.N.Y. 1982) (quoted in Martin, 817 F.2d at 181; Hot Tin Roof, 205 B.R. at 1003; In re Kendavis Industries International, Inc., 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988)). Further, a disinterested person "should be divested of any scintilla of personal interest which might be reflected in his decision concerning estate matters." Codesco, 18 B.R. at 999 (quoted in Martin, 817 F.2d at 181; Hot Tin Roof, 205 B.R. at 1003; Kendavis, 91 B.R. at 754). The most modest interest or relationship will undo a person's disinterestedness if it "would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules." Roberts, 46 B.R. at 828 n. 26 (quoting Philadelphia Athletic Club, 20 B.R. at 334 (quoting COLLIER BANKRUPTCY MANUAL, § 101.13)); Granite, 219 B.R. at 33; COLLIER, P327.04[3][a] at 327-30 (citing and cited in Envirodyne, 150 B.R. at 1017) ("Professional persons employed by the trustee should be free of any conflicting interest which might in the view of the trustee or the bankruptcy court affect the performance of their services or which might impair the high degree of impartiality and detached judgment expected of them during the administration of a case."). From this we see that what is behind prohibiting the existence of a conflict of interest or relationship is the desire to ensure the independence and impartiality of the professional to be retained.

Any determination regarding Graham's disinterestedness would not be complete without also taking into account the fiduciary duties he has as counsel to the chapter 7 trustee. A trustee in bankruptcy, see King v. United States, 379 U.S. 329, 337, 13 L. Ed. 2d 315, 85 S. Ct. 427 (1964); In re Lehal Realty Associates, 101 F.3d 272, 276 (2d Cir. 1996) (a bankruptcy trustee is an officer of the court that appoints him or her); Marvel, 140 F.3d at 474, as well as his or her counsel, are officers of the court. n13 See Securities and Investor Protection Corporation v. Charisma Securities Corporation, 506 F.2d 1191, 1193-1194 (2d Cir. 1974); Grant v. George Schumann Battery and Tire Company, 908 F.2d 874, 884 (11th Cir. 1990); Continental Illinois National Bank & Trust v. Charles N. Wooten, Ltd. (In re Evangeline Refining Company), 890 F.2d 1312, 1323 (5th Cir. 1989). "Where persons perform duties in the administration of the bankruptcy estate, they act 'as officers of the court' and not private persons." Evangeline Refining, 890 F.2d at 1323. "As such, trustees and attorneys for trustees are held to high fiduciary standards of conduct." Id.; Marvel, 140 F.3d at 474; Philadelphia Athletic Club, 20 B.R. at 333 ("the attorney for the trustee had to exercise the same degree of disinterestedness as the trustee himself"); Codesco, 18 B.R. at 999 ("trustee's selection of counsel, however, must be consistent with high standards required of the officers of the federal courts"). These fiduciary duties are owed not only to the entire creditor body but to the debtor as well. See Germain v. The Connecticut National Bank, 988 F.2d 1323, 1330 n.8 (2d Cir. 1993). So the trustee's disinterested counsel must treat with the debtor in accordance with the high standards of conduct expected from fiduciaries in bankruptcy.

Moreover, as an attorney admitted to practice in the State of New York, Graham is subject to the American Bar Association's Code of Professional Responsibility, specifically

Canons 5 and 9, which require that a lawyer exercise independent judgment on behalf of his client and that "a lawyer should avoid even the appearance of impropriety." MODEL CODE OF PROFESSIONAL RESPONSIBILITY, Canons 5 and 9 (1997). Without a doubt, this case differs from the archetypical conflicts case which gives rise to consideration of the Canons. Canon 5 applies by analogy, a situation which is not so unfamiliar in the bankruptcy context because the Canons of Professional Responsibility are not an exact fit in cases involving potentially hundreds of parties and shifting alliances. See Gerald K. Smith, "Standards for the Employment of Professionals in Bankruptcy Cases: A Response to Professor Zywicki's 'Case for Retaining the Disinterestedness Requirement for Debtor in Possession's Professionals,'" 18 MISS. C. L. REV. 327, 357-58 (Spring 1998). If we consider Warshaw Burstein's client to be the trustee and the estate, Canon 5 calls for the firm and, by extension, Graham to exercise independent judgment when making decisions on their behalf, a directive which sounds strikingly familiar to the goals of disinterestedness just discussed. See Martin, 817 F.2d at 181; Hot Tin Roof, 205 B.R. at 1003; Kendavis, 91 B.R. at 754; Codesco, 18 B.R. at 999 (a disinterested person must be devoid of "any scintilla of personal interest which might be reflected in his decision concerning estate matters"); COLLIER, P327.04[3][a] at 327-30.

Most courts acknowledge that to be disinterested also requires an attorney to heed the admonition contained in Canon 9. See Martin, 817 F.2d at 180-81 ("Section 327 is intended ... to address the appearance of impropriety as much as its substance, to remove the temptation and opportunity to do less than duty demands."); Hot Tin Roof, 205 B.R. at 1003; Granite, 219 B.R. at 34 (despite the fact that the Model Rules of Professional Conduct have dropped the appearance of impropriety standard, § 327(a) nevertheless retains it) n14;

Glenn Electric, 99 B.R. at 601 ("the bankruptcy rules in and of themselves incorporate considerations which are the equivalent of Canon 9's 'appearance of impropriety' standard"); Codesco, 18 B.R. at 999; but see Marvel, 140 F.3d at 477 ("We do not believe that BH&P's discussion of § 101(14)(E)'s disinterest requirement, as applied to the disqualification of a trustee, mandates a conclusion that apparent conflicts alone allow a finding of disinterestedness."[15]).

C. Counsel Is Not Disinterested

Just because there is no conflict of interest does not mean that the disinterestedness standard has not been violated and that there has not been a breach of the Canons of the Code of Professional Responsibility. Where there is a conflict, the fear is that counsel's attention and loyalty are divided by the dual representation or that counsel is swayed by an economic or personal interest so that one party is favored over another. See generally Leslie Fay, 175 B.R. 525 (counsel investigating financial irregularities of debtor in possession failed to disclose relationships with directors who were targets of investigation, thereby calling into question validity of investigation as a result of which counsel was sanctioned and removed from all new matters in case). The bottom line concern is that counsel's independent judgment should not be compromised in any way. If the goal is disinterestedness, whether an attorney holds a bias or instead suffers from the likelihood of tainted judgment as a result of a conflict of interest, the wrong is the same, for his or her ability to maintain independence of judgment will be negatively affected.

Another reason why this case is different from the more typical one is, for lack of a better term, the direction of the bias. While the ratio decidendi of most cases dealing with conflicts of interest centers on the actuality or eventuality that counsel will favor or is favoring one party over another, there is a flip side to this coin. Where one party is actively or purposely favored, another party becomes disfavored. Thus, whether counsel is disfavoring one party over another is equally significant to a court's reasoning in determining whether or not counsel is disinterested. The reason the latter construct is probably less often discussed is because the natural course of events assumes the former: that counsel develops a bent in favor of one party which disturbs the balance of impartiality and causes another party necessarily to become slighted, albeit unintentionally. In other words, counsel may not have started off with any bias against this second party.

Graham's attitude is impossible to reconcile with counsel's fiduciary duties to the debtor as well as his duty to avoid even the appearance of impropriety and to exercise independent judgment. Graham is not disinterested as to Vebeliunas as Graham is required to be, either because Vebeliunas is potentially akin to the class of equity security holders under § 101(14)(E) or because Graham fails the disinterest test pursuant to a more expansive reading of the subsection's last clause. His bias impairs "the high degree of impartiality and detached judgment expected from [counsel to the trustee]" during a case. COLLIER, P327.04[3][a] at 327-30; see supra n.11. Without a doubt Graham has leapfrogged right over the mere appearance of impropriety to land four-square on impropriety itself. This is not a situation where ethical concerns are raised by circumstantial evidence. There is direct evidence of actual bias and prejudice against the debtor. Warshaw Burstein was retained to assist the trustee in performing his duties, such as spearheading the investigation of the

financial affairs of the debtor and advising the trustee to oppose the debtor's discharge, if advisable. See 11 U.S.C. § 704. Graham has a fiduciary duty on behalf of the trustee, the estate and the debtor to carry out these tasks impartially. This is why he must be disinterested. In explaining why counsel for a chapter 11 trustee needed to be disinterested, the court in Philadelphia Athletic Club explained:

> This, of course, ... (was) quite sensible, for it would be anomalous indeed to require a trustee to be aloof from all connection with the debtor or its management, yet permit the trustee's attorney, who would necessarily be active in furthering the trustee's duties of investigation, management, prosecution, development of plans and the like, to have a close relationship with the debtor, its management or associates.

Philadelphia Athletic Club, 20 B.R. at 333 (citing 6 L. King, COLLIER ON BANKRUPTCY, P7.06 at 1203 (14th ed. 1978)). Obviously, in that case, the court was concerned that the trustee's counsel's bias would cause him to favor the debtor over the rest of the creditor body. The converse concern is present in this case, but the same reasoning governs. Given Graham's prejudice, it would be naive on my part to expect Graham to be able now to conduct an impartial, untainted and independent investigation of the debtor, particularly since, in Graham's newest papers and aware of my concerns, he nevertheless asserts that he has no duty to be impartial regarding the debtor and has enough information without ever talking to the debtor to disbelieve him. See Graham Affidavit annexed to Warshaw Burstein Affidavit in Opposition to Disqualification, P8.

D. Disinterestedness Aside, Counsel Should Be Removed

At least one court has found that disinterestedness need not be the exclusive test when evaluating the propriety of an attorney's retention. n16 In In re Kurtzman, 220 B.R. 538 (S.D.N.Y. 1998), the district court affirmed the bankruptcy court's refusal to approve the retention of the chapter 7 trustee's chosen counsel. The bankruptcy court had denied the retention because it believed the law firm to be irresponsible with its billing practices and determined that it would not be in the best interest of the estate for the trustee to retain this particular firm. The district court affirmed, reasoning:

> Indeed, section 327(a) vests the authority for "approval" within the sound discretion of the Court. That authority would be eviscerated were the Court required to approve counsel who met the technical test for disinterest but was ill-suited for other reasons such as, for example, inexperience.

Id. at 542. Recognizing that the Third Circuit's decision in Marvel limited disqualification of an attorney on the basis of conflicts of interest to situations involving actual or potential conflicts, the district court remarked:

Marvel, however, did not bar considerations other than conflict of interest in a court's determination of whether to appoint an attorney as trustee's counsel under § 327(a). Thus, while disinterestedness and the absence of conflicts may be central to the inquiry, they are by no means exclusive.

Id. Applying that rationale to this case, I believe Graham is ill-suited to serve as the trustee's counsel because of his expressed prejudice against the debtor. Cf. Plaza Hotel, 111 B.R. at 891-92 (where debtor's counsel exhibited clear gender bias against the chapter 11 trustee and the United States Trustee and an unwillingness to work with them for that same reason, debtor's counsel was disqualified for his unwillingness to assist the debtor in performing its duty to cooperate with them). In addition, if, indeed, the likely litigation surrounding the Lattingtown property results in a judgment that it is property of Vebeliunas' estate, then there is a possibility that Vebeliunas will receive a distribution in his case. With this in mind, Graham's bias takes on new proportions. His fiduciary obligations to Vebeliunas not only with respect to the latter's bankruptcy discharge but also with respect to his potential equity in the Lattingtown property may be compromised by Graham's partiality and impaired judgment.

V.

Without question, I am vested with the authority to disqualify counsel where there is evidence of lack of disinterestedness or an ethical violation justifying such a sanction. See Cheng v. GAF Corp., 631 F.2d 1052, 1055 (2d Cir. 1980) (disqualification is within the court's discretion); W.T. Grant Co. v. Haines, 531 F.2d 671, 678 (2d Cir. 1976); Martin, 817 F.2d at 182 ("it is for the court to decide whether the attorney's proposed interest carries with it a sufficient threat of material adversity to warrant prophylactic action (say, disqualification or disgorgement or invalidation of a lien)."); Leslie Fay, 175 B.R. at 538 (court has wide discretion in its selection of the appropriate remedy). The Second Circuit, however, generally

disfavors disqualification because it can have an immediate adverse effect on the client by separating him or her from his or her counsel of choice. n17 See Nyquist, 590 F.2d at 1246; In re Wingspread Corp., 152 B.R. 861, 863 (Bankr. S.D.N.Y. 1993). On the other hand, an exception to that general rule has been created where the attorney's conduct tends to taint the underlying trial, see Nyquist, 590 F.2d at 1246; Wingspread, 152 B.R. at 863, with any doubts to be resolved in favor of disqualification. See Hull v. Celanese Corp., 513 F.2d 568, 571 (2d Cir. 1975); Wingspread, 152 B.R. at 863.

In this regard, "disqualification has been ordered only in essentially two kinds of cases: (1) where an attorney's conflict of interests in violation of Canons 5 and 9 of the Code of Professional Responsibility undermines the Court's confidence in the vigor of counsel's representation, or, more commonly, (2) when the attorney is at least potentially in a situation to use privileged information concerning the other side through prior representation... " Nyquist, 590 F.2d at 1246 (citing Fund of Funds, 567 F.2d at 232-33; Cinema 5, Ltd. v. Cinerama, Inc., 528 F.2d 1384 (2d Cir.1976); Emle Industries, Inc. v. Patentex, Inc., 478 F.2d 562, 565 (2d Cir. 1973)). It goes without saying that the inquiry is case-specific. See Nyquist, 590 F.2d at 1246; Martin, 817 F.2d at 182 (the bankruptcy judge is on the front line and in the best position to view the situation and make the delicate judgment calls which a disqualification decision entails).

However, while separating a client from his or her chosen counsel will undoubtedly cause disruption, "where the choice of counsel must be approved by the court as appropriate, such that the integrity of the judicial process is implicated, the cost and delay of replacing counsel with a conflict of interest may be outweighed." Leslie Fay, 175 B.R. at 538 (citing Bohack Corp. v. Gulf & Western Industries, Inc. (In re Bohack Corp.), 607 F.2d 258, 263-64 (2d Cir. 1979)). This is

especially true in the bankruptcy context because "the disinterestedness requirement must be strictly enforced." Hot Tin Roof, 205 B.R. at 1003; Consolidated Bancshares, 785 F.2d at 1256 n.6 ("standards for the employment of professional persons are strict, for Congress has determined that strict standards are necessary in light of the unique nature of the bankruptcy process"); Plaza Hotel, 111 B.R. at 890; Philadelphia Athletic Club, 20 B.R. at 333 (tests of disinterestedness to be rigidly applied); Codesco, 18 B.R. at 1000 (citing Woods v. City National Bank & Trust Co., 312 U.S. 262, 269, 85 L. Ed. 820, 61 S. Ct. 493 (1940) (citing Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545 (1928) (Cardozo, J.))) ("only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries 'at a level higher than that trodden by the crowd'"); Michael P. Schuster, "Deciphering Conflicts of Interest in Bankruptcy Representation", 98 COM. L.J. 127, 139 (Summer 1993) (Professional ethical standards are more strictly applied in the bankruptcy context, at least insofar as the retention of professionals by the estate is concerned, in order to maintain the integrity of and respect for the bankruptcy process.).

I have found Graham to be lacking in disinterestedness. To reach this conclusion, I have considered the standards of disinterestedness, the fiduciary duty imposed on counsel as an officer of the court, and the Code of Professional Responsibility. Adopting the analogy between the estate and a client that I suggested before, Graham's prejudice clearly clouds and will continue to cloud his independent judgment when making decisions regarding estate matters in violation of Canon 5, particularly with respect to decisions involving the investigation which he is conducting, the likely Lattingtown property litigation and whether to oppose the debtor's discharge. Inasmuch as Graham is biased, he has also, by definition, committed the "lesser included offense" of not avoiding even the

appearance of impropriety. The breach of Canon 9 is premised on Graham's very real manifestation of impropriety and is not based on any "horrible imaginings alone." Martin, 817 F.2d at 183. Graham is therefore equally subject to disqualification on these grounds since there is a strong threat of taint which would pervade the administration of this case were Graham to remain as counsel to the trustee. See Nyquist, 590 F.2d at 1246. To allow a biased attorney to conduct what is supposed to be an impartial investigation of the debtor, to administer the debtor's estate when the debtor may have an equity therein and to advise the trustee whether to object to the debtor's discharge will undoubtedly engender public suspicion of the integrity of the judicial process. As observed by Judge Friendly in the well-known case In re Ira Haupt & Co., 361 F.2d 164, 168 (2d Cir. 1966), "the conduct of bankruptcy proceedings not only should be right but must seem right." Practically speaking, to consider an economic sanction does not solve the problem because it will leave Graham's bias to reign over the administration of the case. The only way to insure that the investigation of the debtor and the administration of his case are conducted with impartiality and independent judgment is to remove and disqualify counsel from representing the trustee.

VI.

The only remaining issue is whether the whole firm must be disqualified or whether, as the firm requests, only Graham need be removed. The general rule is that when one member of a firm is disqualified, all members of that firm must be similarly disqualified. See United States v. Reynoso, 6 F. Supp. 2d 269, 271 (S.D.N.Y. 1998); Solow v. W.R. Grace &

Company, 83 N.Y.2d 303, 306, 610 N.Y.S.2d 128, 632 N.E.2d 437 (1994); Philadelphia Athletic Club, 20 B.R. at 338 n.11. The reason for this rule is that any interest held by one attorney is imputed to the rest of the lawyers in a firm. If this were not the case, the court would be required to evaluate every other attorney in the firm in order to determine whether they were in fact affected by that interest. See Reynoso, 6 F. Supp. 2d at 271. In correspondence to the court, Edgar Booth, a senior member of Warshaw Burstein who represented that he was speaking on behalf of the whole firm, stated that he has adopted the position espoused by Graham, that neither the trustee nor his counsel is under any duty to give Vebeliunas an opportunity to explain his allegedly questionable behavior because of prior statements by the debtor and the fact that he is a convicted felon. As such, the rationale cited above finds a home in this case as well. If Graham's outlook is to be imputed to Warshaw Burstein, as the firm itself suggests, then the disinterestedness not only of Graham but of the whole firm is defective. The trustee may to some extent be discomfited by having to engage new counsel. However, no § 341 examination has been conducted and the case, while not newborn, is still in its youth. Questions regarding who will administer the Lattingtown property have not even been resolved. Disqualifying counsel may be a set-back in the progress of the case, but it is an unavoidable one, in my opinion. I reiterate my instruction to the trustee to engage new counsel.

SETTLE ORDER on the debtor and the trustee consistent with this decision.

Dated: New York, New York

March 10, 1999

/s/ Tina L. Brozman

CHIEF UNITED STATES BANKRUPTCY JUDGE

----------Footnotes----------

[1] I wish only to use this event in history to describe the potential evils of bias. I express no position whatsoever on the impeachment of President Clinton.

[2] After the hearing, I received a scathing letter from Edgar Booth of Warshaw Burstein, asserting that my ruling had impugned the integrity of not only Graham, but himself and, ultimately, the whole firm. That leap of logic, or illogic, continues to mystify me. Moreover, I am not impugning Graham's integrity as an attorney appearing in this court. What I am saying is that he has exhibited in this case an unfortunate bias which demands his removal.

[3] I have treated this matter de novo, rather than as a motion for reconsideration, inasmuch as Warshaw Burstein questioned whether it received due process the first time round.

[4] To date, no § 341 examination has taken place.

[5] The banks seeking dismissal of the case had asked, when the case was retained, that the state court receiver for the property also be retained. They ultimately withdrew that request in favor of having the trustee administer the property, which, by the way, is income producing. Vebeliunas countered with an assertion that the trustee could not administer the property because it did not belong to the debtor's estate. Graham probably extrapolated from Vebeliunas' petition and his opposition to the request for the trustee to administer the property as well as from documents which the banks showed Graham from the time when their mortgages were granted that Vebeliunas was not credible, despite the fact that Graham

had not yet asked Vebeliunas if there was any explanation for what Graham saw as inconsistencies.

[6] I do not mean to suggest that the debtor is the cooperative, easy-going sort. Graham's frustration and exasperation may be quite legitimate. The issue, however, is not whether Graham has good reason for disliking Vebeliunas.

[7] Quoting Walter Moberly, the dictionary gives a particularly apt illustration of the word's meaning: "The most pernicious kind of bias consists in falsely supposing yourself to have none."

[8] Since standing is limited to parties in interest, see Licensing by Paolo, Inc. v. Sinatra (In re Gucci), 126 F.3d 380, 388 (2d Cir. 1997), if Vebeliunas has standing to object, then he should most obviously also be considered a party in interest.

[9] The lack of precision in the statute may well be due to Congress' desire to have one standard of disinterestedness apply to professionals for all sorts of debtors' estates be they corporate, partnership or natural persons.

[10] In its discussion of the term "disinterested person" as defined in § 101(13) - now renumbered § 101(14) - the Bankruptcy Reform Act of 1978, Collier states:

> The enunciated elements provide a minimum standard for the guidance of the court in its appointments, and insure that the persons employed shall have the essential character of independence and disinterestedness which is required. These elements do not, however, establish an exclusive standard. As was the case under pre-Code bankruptcy practice, (continued by virtue of the "catchall" provision of clause (E)), if a court deems a particular

person's associations to be prejudicial to disinterestedness, it may reject him even though those associations do not come strictly within the purview of section 101(13). Thus, the phrase "or for any other reason" permits the court to find a particular person lacking in disinterestedness for reasons other than the non-exclusive statutory guidelines.

As noted above, clause (E) may be termed a "catch-all clause," and it seems broad enough to include anyone who in the slightest degree might have some interest or relationship that would even faintly color the independent and impartial attitude required by the Code and Bankruptcy Rules. The reasons supporting this extensive inclusion are the same, of course, as those previously recounted. Indirect or remote, as well as direct, associations or affiliations may engender conflicting loyalties.

* * *

It is clear, therefore, that the definition of disinterested person in paragraph (13) promotes the policy that as a general principle professionals engaged in the conduct of a bankruptcy case should be free of the slightest personal interest which might be reflected in their decisions concerning matters of the debtor's estate or which might impair the high degree of impartiality and detached judgment expected of them during the course of administration.

1 COLLIER BANKRUPTCY MANUAL, § 101.13 (1981).

[11] The following case are examples of courts using the "high degree of impartiality and detached judgment" language quoted above or its slight variation "faintly color the independent and impartial attitude required by the Code," also from the same COLLIER BANKRUPTCY MANUAL excerpt, to elucidate disinterestedness: Crivello, 134 F.3d at 835; In re BH & P, Inc. 949 F.2d 1300, 1308 (3d Cir. 1991); Martin, 817 F.2d at 181; Piersen & Gayler, Ray & Terrell & Grubbs v. Creel & Atwood and Jack Bryant (In re Consolidated Bancshares, Inc.) 785 F.2d 1249, 1256 (5th Cir. 1986); Winship v. Cook (In re Cook), 223 B.R. 782, 789 (B.A.P. 10th Cir. 1998); Hot Tin Roof, 205 B.R. at 1003; In re Glenn Electric Sales Corp., 99 B.R. 596, 601(D.N.J. 1988); Roger J. Au & Son, Inc. v. Aetna Insurance Company (In re Roger J. AU & Son, Inc.), 64 B.R. 600, 604 (N.D. OH. 1986); In re Quality Beverage & Company, 216 B.R. 592, 595 (Bankr. S.D. Tex. 1995); Granite, 219 B.R. at 33; In re Prudent Holding Corp., 153 B.R. 629, 631 (Bankr. E.D.N.Y. 1993); Envirodyne, 150 B.R. at 1017; In re Ochoa, 74 B.R. 191, 193 (Bankr. N.D.N.Y. 1987); In re Kendavis Industries International, 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988); Roberts, 46 B.R. at 829; Philadelphia Athletic Club, 20 B.R. at 334 (citing COLLIER BANKRUPTCY MANUAL, § 101.13); In re Codesco, 18 B.R. 997, 999 (Bankr. S.D.N.Y. 1982). [*27]

[12] This language is only slightly modified in the current edition of COLLIER ON BANKRUPTCY. See 4 L. King, COLLIER ON BANKRUPTCY, P327.04[3][a] at 327-30 (15th ed. rev. 1996).

[13] Obviously, both chapter 7 and chapter 11 trustees are officers of the court. Many of the cases discussing the fiduciary duties of a trustee and his or her counsel are those involving chapter 11 trustees, which, independently under the

Bankruptcy Code, must be disinterested. See § 1104(b). Although that may not be a requirement for a chapter 7 trustee elected by creditors, it is a requirement for an interim trustee that becomes a permanent trustee under § 702(d) because interim trustees are required to be disinterested under § 701(a)(1). Such is the case here. Accordingly, those cases describing the fiduciary duties of counsel to a disinterested trustee also apply here.

[14] New York has not adopted the newer American Bar Association's Model Rules of Professional Conduct but adheres to the Model Code of Professional Responsibility.

[15] Although the word "disinterestedness" is employed in this sentence, it is clear from the context that the Third Circuit intended interestedness or lack of disinterestedness. In this vein, because I find Graham has demonstrated bias, my holding that he is not disinterested on that basis does not run afoul of the teachings of Marvel. The Third Circuit in Marvel acknowledged a per se rule for disqualification of counsel holding an actual conflict of interest, a rule for discretionary disqualification of counsel with a potential conflict of interest and a prohibition against disqualification of counsel based on an appearance of conflict alone. See Marvel, 140 F.3d at 476.

[16] If one reads the last clause of § 101(14)(e), "or for any other reason," broadly, as I believe is its proper construction, then Kurtzman could come within the failure of disinterestedness.

[17] Another reason motions for disqualification are frowned upon is that they are often interposed for tactical reasons. See Nyquist, 590 F.2d at 1246. However, this concern is not a factor here considering that I have raised the issue on my own motion.

Supreme Court, U.S.
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(3)

No. 98-1643

IN THE
Supreme Court of the United States

IN THE MATTER OF: SOUTHMARK CORPORATION,
Debtor.

SOUTHMARK CORPORATION,
Petitioner,

v.

COOPERS & LYBRAND L.L.P.,
Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

REPLY BRIEF FOR PETITIONER

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STATUTE

28 U.S.C. § 157(b)(3) 3

Respondent's brief in opposition urges this Court to ratify the Fifth Circuit's sweeping vision of the role of bankruptcy courts and to grant these Article I tribunals a broad jurisdiction plainly prohibited by this Court's decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). In advancing this novel theory, Coopers & Lybrand L.L.P. ("Coopers") fails to explain how a bankruptcy court constitutionally forbidden from adjudicating "state-created private rights," *id.* at 71, could have adjudicated Southmark Corporation's ("Southmark's") state-created cause of action for malpractice. Nor does Coopers show how Southmark's action, filed nearly five years after its emergence from bankruptcy, falls within a bankruptcy court's core jurisdiction—a narrow zone which this Court has limited to "the restructuring of debtor-creditor relations." *Id.*

Coopers' brief succeeds only in demonstrating why review of the Fifth Circuit's decision is needed. Under the lower court's reasoning, *any* lawsuit against *any* court-appointed professional automatically falls within a bankruptcy court's core jurisdiction. Such a result not only violates the constitutional limits this Court recognized in *Marathon*, but directly conflicts with the holdings of other courts of appeals that have denied bankruptcy courts the power to adjudicate state-law claims against trustees and other court-appointed professionals.

I. Coopers Fails To Reconcile The Fifth Circuit's Holding With The Jurisdictional Limits Established In *Marathon*

Confronted with an adjudication plainly violative of a bankruptcy court's jurisdictional limits,

Coopers repeatedly invokes its status as a court-appointed professional in an attempt to force this lawsuit into the narrow confines of core jurisdiction. Neither this argument, nor Coopers' reliance on assorted policy goals, can trump the unambiguous mandate of *Marathon*: State-created private rights must be adjudicated by an Article III decisionmaker.

A. Contrary To Coopers' Argument, Lawsuits Against Court-Appointed Professionals Are Not Automatically Core Proceedings

In defending the decision below, Coopers advances the proposition—never before accepted by this or any other court—that state-law tort claims against bankruptcy court-appointed professionals automatically qualify as core proceedings because they "cannot be divorced from the bankruptcy context." Opp. 3. This theory is flatly contradicted by *Marathon*, which held that the core/non-core inquiry is guided by the substantive nature of the asserted right, public or private—*not* by the setting in which the right arises or by the identity of the parties. 458 U.S. at 69-70. If the right is a "state-created private right," it must be adjudicated by an Article III court. *Id.* at 71. *See also In re United States Brass Corp.*, 110 F.3d 1261, 1268 (7th Cir. 1997) (Posner, C.J.) ("Core proceedings are actions by or against the debtor that arise under the Bankruptcy Code in the strong sense that *the Code itself* is the source of the claimant's right or remedy.") (emphasis added).

Coopers does not dispute that the rights Southmark asserts are private rights created by the State of Texas. Nor does Coopers dispute that

resolution of Southmark's claims turns entirely upon state law.[1] Instead, Coopers ignores the substantive nature of these claims and argues that its mere status as a court-appointed professional suffices to trigger a bankruptcy court's core jurisdiction, noting that it owed duties to the bankruptcy court as well as to Southmark. Opp. 3. The flaw in Coopers' argument is simply this: Southmark's malpractice lawsuit did not implicate any duties Coopers owed to the bankruptcy court. The duty Coopers breached was a duty to *Southmark* imposed under Texas law; any duties Coopers may have owed to persons or entities other than Southmark are entirely irrelevant to this proceeding.

Coopers' argument amounts to a claim that Southmark must be divested of its constitutional right to an Article III decisionmaker because Coopers violated its duty to the court in addition to its duty to Southmark. Yet the fact that Coopers violated its duties under the Bankruptcy Code is immaterial to the question whether Southmark is entitled to an adjudication of its state-created rights by an Article III court. In any event, Coopers'

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[1] Coopers' contention that the Bankruptcy Code, 28 U.S.C. § 157(b)(3), somehow encourages bankruptcy courts to determine state-law claims is wholly misplaced. As an initial matter, this subsection merely provides that state-law claims are not *automatically* non-core; if anything, the provision *discourages* bankruptcy courts from deciding matters arising under state law. More important, Coopers' response ignores the central point of Southmark's argument: The jurisdictional limit the bankruptcy court violated by adjudicating Southmark's state-law action was a constitutional rather than statutory limit. Section 157(b)(3) cannot be read to authorize what *Marathon* forbids.

reasoning is impossible to reconcile with this Court's holding in *Marathon*, which recognized that an ordinary tort suit—a private right of action that concerns "the liability of one individual to another," 458 U.S. at 69—*requires* adjudication by an Article III court.

Coopers contends that "ensuring the disinterestedness of court-appointed professionals is essential to the proper functioning of the bankruptcy court and therefore is within the core bankruptcy power." Opp. 4. Even if true, this observation is entirely beside the point. Bankruptcy courts can ensure the disinterestedness of their appointees through a wide variety of sanctions and other policing mechanisms, *see* Pet. 18, yet the availability of these sanctions in no way limits a victimized party's right to seek redress under state law in an Article III court.[2] All the cases cited by Coopers stand for the unremarkable proposition that bankruptcy courts have a duty to ensure that their appointees are in fact disinterested. *See, e.g., Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994). None of the cases recognize the rule Coopers purports to elicit: that the Constitution empowers an Article I bankruptcy court to adjudicate, nearly five years after the bankruptcy proceedings have concluded, a private tort action arising under—and governed by—state law.

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[2] In an analogous context, this Court, in *Business Guides, Inc. v. Chromatic Communications Enters., Inc.*, 498 U.S. 533, 553 (1991), explained that the sanctioning provisions of the Federal Rules of Civil Procedure serve a different purpose than private suits in tort, emphasizing that "we are confident that district courts will resist the temptation to use sanctions as substitutes for tort damages."

Finally, Coopers' attempts to distinguish this Court's rulings in *Marathon* and *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989), fall short of persuasive: Coopers suggests that these cases were actually decided on a different basis than the one the Court articulated. According to Coopers, the claims in *Marathon* (breach of contract and warranty, misrepresentation and duress) and in *Granfinanciera* (fraudulent conveyance) were non-core because they "related to pre-petition conduct that possessed neither a temporal nor structural nexus to the bankruptcy process." Opp. 5. Coopers fails, however, to identify any language supporting its revisionist interpretation. This is not surprising: *Marathon* "emphasized that state-law causes of action for breach of contract or warranty are paradigmatic private rights, *even when asserted by an insolvent corporation in the midst of Chapter 11 reorganization proceedings*." *Granfinanciera*, 492 U.S. at 56 (emphasis added). Similarly, the *Granfinanciera* Court likened fraudulent conveyance claims to "state-law contract claims brought by a bankrupt corporation" that were not "integral to the restructuring of debtor-creditor relations." *Id.* at 56, 58. Absent in both of these cases is any suggestion that the holding hinged on the timing of the tortious conduct (pre- or post-petition) or the existence of a "temporal" or "structural" nexus to bankruptcy.

B. Coopers' Defense Of The Decision Below Rests On A Blatant Mischaracterization Of Southmark's Claims

Implicitly acknowledging the impropriety of the bankruptcy court's adjudication of a malpractice lawsuit, Coopers repeatedly mischaracterizes

Southmark's claims as "essentially fee objections." Opp. 7. From this faulty predicate, Coopers reasons that permitting another court to hear Southmark's claim would "seriously undermine the power of the bankruptcy court to control the conduct of court-appointed officers." Opp. 4, 6. This argument echoes the Fifth Circuit's conclusion, Pet. App. 12a, that Southmark's malpractice claim implicates "the court's ability to police the fiduciaries . . . who are responsible for managing the debtor's estate in the best interest of creditors."

Coopers lacks any basis—indeed, it identifies none—for equating Southmark's lawsuit to a claim for fees. Southmark sued Coopers not for disgorgement of fees under the Bankruptcy Code, but under Texas tort law for the $20 million-plus in damages that Southmark claims was caused by Coopers' wrongful conduct, in addition to punitive damages. Coopers' brief fails to acknowledge that a disgorgement proceeding and a malpractice lawsuit vindicate separate and distinct interests. The former vindicates the *public* interest in ensuring that Coopers fulfills its duties to the court; the latter vindicates Southmark's *private* interest in ensuring that Coopers fulfills its duties, as determined under Texas law, to Southmark. By any measure, a malpractice suit is not a disgorgement proceeding, yet Coopers' entire argument depends on their conflation.

Other than its own *ipse dixit*, Coopers offers no basis for concluding that a bankruptcy court's ability to supervise the performance of its appointees would be threatened by denying it jurisdiction to decide malpractice claims. Coopers blithely ignores the arsenal of sanctioning provisions available to bankruptcy courts. *See* Pet. 18. Instead, Coopers

points to *In re Linton*, 136 F.3d 544, 545 (7th Cir. 1998), which merely applied the federal common law rule, recognized for well over a century, that someone wanting to sue a trustee in bankruptcy concerning actions taken by him in the course of his trusteeship must obtain the permission of the bankruptcy court. *Linton*, which does not concern core jurisdiction, is completely inapposite. It does not cite *Marathon*, nor does it even purport to authorize Article I courts to adjudicate matters this and other courts have consistently deemed non-core.[3]

II. Coopers' Own Argument Confirms The Existence And Severity Of The Circuit Splits Regarding Core Jurisdiction

Coopers' insistence that the courts of appeals are in harmony over the question whether core jurisdiction encompasses state-law claims against court-appointed professionals is belied by its own argument. As Coopers explains, the Fifth Circuit concluded that Southmark's claims were core because "without the bankruptcy proceeding, Coopers would have had no relationship with Southmark and the claims would not exist." Opp. 5. This holding cannot be reconciled with the Third Circuit's decision in *Torkelson v. Maggio (In re Guild and Gallery Plus, Inc.)*, 72 F.3d 1171 (3d Cir. 1996). There, the court held that negligence and conversion claims against a Chapter 7 trustee were

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[3] Coopers also relies on *Linton* to suggest that Southmark somehow seeks to make a collateral attack on the result of the disgorgement proceeding. This argument is meritless. As Coopers acknowledges, Opp. 7, Southmark *prevailed* on its motion for disgorgement; Coopers was ordered to pay $585,000.

non-core—even though, under the Fifth Circuit's reasoning, "without the bankruptcy proceeding, [the trustee] would have had no relationship with [the plaintiff] and the claims would not exist." *Guild and Gallery* illustrates the circuit split over when a state-law claim against a court-appointed professional constitutes a core proceeding.[4]

Coopers' attempt to reconcile the Ninth Circuit's decision in *Taxel v. Electronic Sports Research (In re Cinematronics, Inc.)*, 916 F.2d 1444 (9th Cir. 1990), is similarly meritless. Coopers does not contest the court's central holding that claims—even those that arise post-petition—are non-core when they do not "directly affect the estate or the confirmation of the estate's plan," *id.* at 1450. Nor does Coopers dispute that the suit against the debtor's president was deemed non-core, even though the president served with the approval of the bankruptcy court. *Id.* at 1446-47. Instead, Coopers argues, Opp. 12, that the decision is suffused with "ambiguity" that subsequently "evaporated" with the Ninth Circuit's decision in *Walsh v. Northwestern Nat'l Ins. Co. (In re Ferrante)*, 51 F.3d 1473 (9th Cir. 1995). *Ferrante*, however, stands only for the narrow and unremarkable proposition that a proceeding involving a trustee's

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[4] The Third Circuit's prior decision in *Billing v. Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242 (3d Cir. 1994), is not to the contrary. As Coopers concedes, Opp. 10, the question of core jurisdiction was not raised on appeal and therefore "was not addressed directly by the court." Moreover, the district court's ruling, 150 B.R. 563, rested on the fact that—unlike here—the plaintiffs' claims could not be evaluated without assessing the defendants' duties under the Bankruptcy Code in connection with the reorganization.

embezzlement of estate assets falls within core jurisdiction. The case most assuredly does not suggest that *all* proceedings against court-appointed professionals are core, particularly where, as here, the lawsuit is predicated on state-created rights as opposed to federal duties imposed by the Bankruptcy Code.[5]

A recent decision from the Eleventh Circuit only exacerbates the conflict. In *Continental Nat'l Bank v. Sanchez (In re Toledo)*, 170 F.3d 1340 (11th Cir. 1999), the court held that a lawsuit against a bankruptcy trustee, the debtors, and the bank was non-core. The court explained that—even though the trustee was sued for conduct he performed pursuant to his official duties—the action to determine the validity of liens "did not invoke a substantive right created by bankruptcy law" but concerned "essentially a state-law right based on principles of contract and/or fiduciary duty." *Id.* at 1349 & n.11. The court concluded that because the property in dispute did not belong to the debtor's estate and because the suit "sought to vindicate state-created common-law rights but did not utilize any process specially established by the Bankruptcy Code," it fell outside the scope of core jurisdiction. *Id.* at 1350.

Review by this Court is warranted to resolve the split among the Circuits on this important and recurring question, and to clarify the bounds of core jurisdiction.

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[5] Nor can *Ferrante* be read as overruling *Cinematronics*. "[O]nly a panel sitting en banc may overturn existing Ninth Circuit precedent." *United States v. Camper*, 66 F.3d 229, 232 (9th Cir. 1995).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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